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Jerry L. Jordan	Jobs Creation and Government Policy
Robert Krol	A Survey of the Impact of Budget Rules on State Taxation, Spending, and Debt
Charlotte Twight	Medicare's Origin: The Economics and Politics of Dependency
Ralph Chami and Connel Fullenkamp	The Market Value of Family Values
Robert Taylor	Compensating Behavior and the Drug Testing of High School Athletes
Donald J. Boudreaux and Dwight R. Lee	Politics as the Art of Confined Compromise

BOOK REVIEWS

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CATO JOURNAL • VOLUME 16 NUMBER 3 • WINTER 1997

ARTICLES

Jerry L. Jordan
Jobs Creation and Government Policy 287

Robert Krol
A Survey of the Impact of Budget Rules on State Taxation, Spending, and Debt 295

Charlotte Twight
Medicare's Origin: The Economics and Politics of Dependency 309

Ralph Chami and Connel Fullenkamp
The Market Value of Family Values 339

Robert Taylor
Compensating Behavior and the Drug Testing of High School Athletes 351

Donald J. Boudreaux and Dwight R. Lee
Politics as the Art of Confined Compromise 365

BOOK REVIEWS

The Capitalist Revolution in Latin America
Paul Craig Roberts and Karen LaFollette Araujo

Reviewed by Carlos A. Ball 383

What It Means to Be a Libertarian
Charles Murray

Reviewed by Randolph J. May 386

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ELECTRONIC REPRODUCTION PROHIBITED

Asia Rising
Jim Rohwer

Reviewed by Sonia Wong 390

Competition and Finance: A Reinterpretation of Financial and Monetary Economics
Kevin Dowd

Reviewed by Leland B. Yeager 394

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Jobs Creation and Government Policy

Jerry L. Jordan

Before the Great Depression of the 1930s, the notion that government ought to be responsible for creating jobs would have seemed absurd. Today, however, we commonly hear aspiring politicians declare that their number-one economic objective would be to increase employment.

The intellectual justification for gearing government budgetary and monetary policies toward fine-tuning the economy (and, in particular, toward generating more employment) was provided by John Maynard Keynes (1936) in *The General Theory of Employment, Interest, and Money*. This landmark book laid the cornerstone for the economic doctrine that dominated macroeconomic policies for several decades following World War II. Indeed, since the mid-1930s, the dominant view of economic policymakers has been that a competitive marketplace will fail to generate adequate employment opportunities. This view underlies the advocacy of government programs to "create jobs."

I am reminded of a story that a businessman told me a few years ago. While touring China, he came upon a team of nearly 100 workers building an earthen dam with shovels. The businessman commented to a local official that, with an earth-moving machine, a single worker could create the dam in an afternoon. The official's curious response was, "Yes, but think of all the unemployment that would create." "Oh," said the businessman, "I thought you were building a dam. If it's jobs you want to create, then take away their shovels and give them spoons!"

In the final decade of this century, the Depression-era way of thinking about the role of government is fading. In the 21st century, creating work for people will not be viewed as a primary objective

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of government policy; fostering an environment for wealth creation will be.

Creating Work versus Creating Wealth

Work is the necessary means of achieving wealth: in order to be consumers, we must also be producers. Whatever good intentions are presumed, when the government focuses away from creating wealth and onto creating jobs, it inevitably engenders a lower average standard of living. A successful, wealth-augmenting government policy should simultaneously reduce the work burdens of the labor force. That does not mean people will need to share jobs, take low-paying jobs, or become unemployed. Wealth creation occurs as the "muscle" component of employment diminishes and the "brainware" component increases.

The work record of industrialized countries in the past century is clear. In the United States, for example, the average workweek has fallen by more than 40 percent in the last 100 years. Among the benefits of wealth accumulation is the increase in leisure that it affords. Very poor nations are typically characterized by people who work most of their waking hours. To do otherwise would be disastrous. Where one finds impoverished nations with high rates of joblessness, one also finds political-economic systems that have large disincentives to create and accumulate wealth.

The distinction between creating wealth and creating "work" can be illustrated by an economy that has experienced a catastrophic natural disaster. A well-known feature of market economies is that in the wake of a disaster, such as a hurricane or earthquake, employment and production tend to rise. One conclusion might be that market economies routinely hoard unused labor services—workers who are gratefully called into service by the new demands of rebuilding houses, roads, and all of the other investments that were damaged or destroyed.

But clearly, society is not better off because people are working long, hard hours. A more reasoned conclusion is that these natural disasters are destroyers of wealth—and creators of work in the sense that households and firms must now toil harder to help recover from their losses. I doubt that this is the sort of "jobs creation" program voters have in mind when they cast their ballots, although I suspect that many government "jobs" programs operate much like a post-disaster cleanup program.

Government and Jobs Preservation

Given the importance politicians generally assign to the task of creating employment for people, it is surprising how little they know

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about the nature of jobs creation in market economies. Studies of the U.S. record show no identifiable, systematic factors related to industry, region, wages, employer size, capital and energy intensity, or foreign competition that would account for a significant share of the types or number of jobs created or destroyed in the economy.

Because policymakers have no clear foresight of where entrepreneurial energies will be directed in the future, it is impossible for them to predict where jobs creation should occur. For example, two or three years ago, who could have predicted, let alone planned, that a rapidly growing occupation for people would be designing Web sites? It is not surprising, then, that government policies which seek to direct the flow of entrepreneurial talents in an effort to promote "good" jobs, and presumably to discourage "bad" jobs, will have uncertain and potentially negative effects on economic prosperity.

Government-targeted employment policies breed special interest groups that inevitably reduce the efficiency of markets in allocating scarce resources. These policies tend to persist beyond the point of any economic desirability and inhibit a necessary antecedent to jobs creation: jobs destruction. In the United States, sectors and industries that claim the highest rates of jobs created are generally those that have the greatest rates of jobs destroyed (Davis, Haltiwanger, and Schuh 1996: 39). Similarly, nations with high rates of jobs creation also tend to have high rates of jobs destruction.

In modern economies, can we conceive of any jobs creation that is not preceded by the destruction of some less efficient, and therefore less prosperous, jobs? Indeed, can we conceive of any major advance that does not make obsolete some less efficient way of producing things?

I am of the generation that can still operate a slide rule—for what purpose I can only scarcely remember. But this technology must necessarily have been supplanted by the invention of electronic calculators, and already, miniature personal computers are making calculators obsolete. This is the nature of progress—to make obsolete old technology. Innovation is the process of "creatively destroying" the pre-existing order.[1]

Because of their imperfect vision, government jobs programs are almost everywhere jobs protection policies, which by extension tend to inhibit the creation of new, wealth-enhancing technology. Europe's stagnant labor markets are a direct result of labor laws and regulations

[1]On the "process of creative destruction" under capitalism, see Schumpeter (1942) and Lee and McKenzie (1993).

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designed to protect existing jobs, even at the social cost of discouraging new capital formation and, therefore, wealth creation.

Borders, Prosperity, and Capital Freedom

The two sides of a political border illustrate what government can and cannot accomplish. Why economic prosperity varies greatly along a seemingly arbitrary boundary poses perhaps *the* critical question for an economic policymaker. What is the economic importance of borders that separate prosperity on one side and poverty on the other?

In the simplest terms, there can be only two reasons for divergent levels of per capita income: (1) different levels of resources or (2) differences in the allocation of resources, which may be either how the resources are employed or how many of the resources are employed. Moreover, these two sources of economic prosperity are interdependent: how a nation decides to allocate its resources will ultimately determine how many resources it has to allocate.

Borders often mark varying degrees of capital fertility—the incentives that promote the propagation of new capital that allows rich regions to achieve and maintain higher standards of living. The resources of the industrialized world were not all endowed; most were created by entrepreneurial effort within a congenial political-economic system. Entrepreneurial effort is not manufactured by social engineers, but allowed to take root naturally in an economic soil untainted by deliberate policy intervention.

The Role of Government in the Economy

Government's role in the economy was laid out a decade ago in a wonderful essay, "The Poverty of Nations," by the late economist Karl Brunner (1985). A person in an economy can use resources in only one of four basic endeavors: he can produce, trade, influence the political process to redirect greater resources to his advantage, or protect himself against the wealth-redistributing efforts of others.

In the first two uses—production and trade—the total welfare generated by the economy increases. In the language of economists, these activities represent a positive-sum (win–win) gain. However, the latter two efforts—redirecting the flow of resources and protecting against the wealth-redistributing efforts of others—are zero-sum, or even negative-sum, games. They add no value, waste time and effort, and thus generate a lower standard of living for people as resources are directed away from production and trade. Government institutions—laws, rules, regulations, and the judicial system—influence private decisions to allocate resources among these uses.

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The influence of government as a wealth-redistributing body is well known. Government wealth redistribution by way of explicit or implicit taxation lowers the incentive to create and accumulate wealth, thereby lowering the potential productive power of the economic system. But governments also promote production and trade, because they are assigners and protectors of property rights, and provide for the enforcement of private contracts. These are wealth-enhancing activities that help the productive capacity of an economy to blossom. Thus, governments have two necessarily contradictory and coexisting modes: "the protective mode" and "the redistributive mode."

These modes suggest why arbitrary borders along a political boundary generally signify regions of varying prosperity. They are the frontiers of a government's authority and, as such, they mark the varying degrees of both the protective and redistributive modes. Both of these roles can negatively influence a nation's economic landscape: too little protective power, or too much redistributive effort, inhibits the creation and retention of wealth and retards equilibrating forces that attempt to provide a standard of living comparable to that in neighboring countries.

Now that the concrete and barbed-wire walls that separated the Eastern and Western European economies no longer exist, we can expect to see a narrowing in the wealth differentials between the two regions. However, until a legislative and judicial infrastructure has been built that enhances the protective mode of government in the former Communist bloc countries, the gap in economic well-being will not be closed.

A necessary precondition for the accumulation of capital is the protection of property rights. Those countries that make the most rapid progress in adopting Western legal, financial, and accounting practices will usher in a new era of prosperity for their economies. Similarly, until the redistributive modes of many Western European economies are substantially curtailed, the stagnation in their standards of living will surely persist.

The ability of governments to influence wealth creation has been documented in a recent study produced by a consortium of research institutes in Canada, Mexico, and the United States (Gwartney, Lawson, and Block 1996). The study attempted to gauge, in a methodical way, the degree of economic freedom in each of a broad cross-section of nations. The conclusion from examining more than 100 countries over a 20-year period was that governments with a strong commitment to economic liberty—including the freedom of exchange and the protection of private property—tended to be faster-growing and wealthier. No nation with a persistently high economic freedom rating

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failed to achieve a high level of income. Furthermore, the 17 countries with the most improved freedom ratings all had positive and generally strong growth rates, while the 15 countries where economic freedoms declined recorded real per capita wealth declines.

A Wealth-Creation Role for Monetary Policy

There is a presumption that monetary policy in industrial democracies has two objectives: (1) to promote price stability and (2) to promote employment growth. Although many contend that these objectives are in conflict, I disagree. It is false to conclude that a tradeoff exists between price stability and jobs creation. Such a perception puts proponents of stable monetary systems in the position of appearing to be anti-jobs. On the contrary, by protecting the purchasing power of a nation's money—and thereby protecting the property rights of the private enterprises that use the publicly provided money—the central bank promotes the creation and accumulation of wealth.

The alternative—allowing the purchasing power of a nation's monetary standard to erode over time—redirects resources from activities that create wealth toward efforts to protect existing wealth from the ravages of inflation and currency devaluations. If the redistributive effects become great enough—that is, if inflation becomes extremely high—people will abandon the domestic monetary standard and replace it with one that is set outside the country.

For example, the share of U.S. currency held outside the country has been increasing rapidly, so that today, more than two-thirds is held by non-U.S. residents. In the 1980s, the bulk of new U.S. currency was held in Latin America, where the dollar is commonly used to settle ordinary auto and real estate transactions. Since the tumbling of the Berlin Wall at the end of 1989, currency flows in Eastern Europe and the former Soviet republics have grown enormously as the dollar has become a readily accepted medium of exchange in these emerging market economies. In fact, in 1994, U.S. currency transfers to Russia alone accounted for more than half of all net foreign currency movements. In 1995, gross shipments of U.S. currency to Russia were reported to have been as high as $100 million per business day (Porter and Judson 1995).

The reason for the competing monetary system in Russia is clear: In order to gain revenue from seigniorage, the Russian central bank printed rubles rapidly, thereby debasing the domestic currency. Then, the implicit inflation tax on ruble transactions provided the incentive for Russian citizens to use a more stable currency—the U.S. dollar.

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When we think of money as a public good that facilitates the operation of markets, we begin to see that a stable monetary standard need not be anti-jobs creation, but is pro-wealth creation. This is the realization in a wide variety of market economies around the world. In recent years, many nations have adopted targeting low or zero inflation as the sole objective of their central banks. In large part, those governments had become disenchanted with the role of the monetary authority as a fine-tuner of the economy. In virtually each instance, the unintended consequences of misguided short-run "countercyclical stabilization policies" were that the purchasing power of their monies became unstable, fluctuations in business activity grew worse, and wealth was eroded.

Evidence of the negative effect of inflation on wealth creation is incomplete, but there is little doubt that this effect is becoming widely recognized. For instance, a recent study for the Bank of England reported that a 10 percentage point increase in average inflation reduces the growth rate of real per capita income by about one quarter of a percentage point and lowers the ratio of investment to GDP (Barro 1995). These results imply that, over the long run, inflation can have a significant effect on a nation's standard of living. This finding is consistent with work by economists at the Federal Reserve who found "a negative correlation between inflation and the growth of productivity over the post–Korean War period in the United States" (Rudebusch and Wilcox 1994).

Economists will debate the details on how best to implement a stable price objective for central banks. Indeed, such debates have been occurring in the United States for many years now, as they have around the world. But there is one essential element of this objective: governments must abandon the notion that unstable inflationary payments systems are useful wealth (and jobs) creation strategies. The record on this point is clear. To allow for the highest standard of living, the central bank must provide the greatest possible incentive for the creation and accumulation of wealth. That, above all else, means that it must provide a stable monetary system.

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A Survey of the Impact of Budget Rules on State Taxation, Spending, and Debt

Robert Krol

State government spending has grown dramatically out of proportion to inflation and population growth. Between 1950 and 1990, real state spending grew by more than 500 percent. Real state spending grew two and one-half times faster than population during the 1970s and four times faster than population during the 1980s (Stansel 1994).

This paper reviews the empirical evidence on the impact of budget rules on the size and growth of state government. What affect do tax and expenditure limitations, the line-item veto, and balanced-budget laws have on government tax and spending behavior? Do these rules alter debt issuance and off-budget spending?[1]

Budget rules have been suggested as a means of controlling federal spending. Examination of these rules at the state level can provide important evidence about their potential effectiveness and optimal design. Currently, 23 states have some kind of tax or expenditure limitation, 49 states have requirements to balance the budget (the exception is Vermont), and 40 governors have the power to veto specific line-items of their states' budgets.

Many models of government explain public-sector behavior by treating institutional arrangements as a given. The equilibrium level of spending in the median-voter model (Downs 1957) is set to maximize the net benefits of the median voter, independent of institutional detail. The Tiebout model (Tiebout 1956) also ignores budget rules in determining the optimal size of government. The existence of

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[1]The list of institutions that influence government behavior can be expanded. For example, there is evidence that decentralization of budget decisionmaking (Crain and Muris 1995) and term limits (Besley and Case 1995) influence government spending and taxation. I focus on the three most common direct budget rules.

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legislation directed at constraining politicians poses a challenge to these theories of government.

The special-interest model of government (Stigler 1971, Peltzman 1976, and Becker 1983), the monopoly model (Niskanen 1975), and the Leviathan model (Brennan and Buchanan 1979) all suggest the need for budgetary rules. In these models, equilibrium spending is greater than optimal and budget rules are needed to constrain politicians' tax and spending behavior.

In addition to reviewing the evidence on budget rules, a second objective is to illustrate the influence of empirical methodology in policy analysis. Early studies used cross-sectional data, which has serious empirical limitations. Results may be biased by the year chosen and researchers cannot control for unobserved factors. More recent studies use panel data (cross-sectional time-series data), producing more reliable estimates (see Hsiao 1986). Also, failure to take into account the endogeneity of budget rules can seriously bias results. If states with rapid spending growth are more likely to impose budgetary rules, then any association between rules and spending may be distorted.

Tax and Expenditure Limitations

A growing number of states have tax and expenditure limitations (TELs). TELs are laws that specify how much taxes or expenditures can increase from one year to the next. They usually limit the increase to the growth in state personal income or population growth plus inflation.

Not all TELs are the same. Some are initiated by citizens, through state initiative processes. Others are crafted in state legislatures. Of the 23 states with TELs, 8 states have TELs that were initiated by citizens, the remaining TELs were written by legislators. Because legislators constrain their own ability to cull political support when they limit state spending, we would expect TELs written by legislatures to be more flexible, to have more loopholes, and to be less binding.

TELs can be constitutional amendments or statutory laws. Constitutional amendments are difficult to modify. Statutory laws can be changed by legislative action. When spending becomes constrained by TELs, states whose TELs have only statutory authority may be more subject to revision, mitigating their usefulness in restricting spending. Of the 23 state TELs in existence today, 11 are constitutional.

The existence of a TEL may not be sufficient to influence the size of government. The way a TEL is written can have an important impact on its effectiveness. Hidden loopholes may make it easy for a

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state legislature to work around the law. For example, expenditures can be shifted to an off-budget agency.

Empirical studies through 1990 found mixed results as to the effectiveness of TELs. Papers by Abrams and Dougan (1986), Cox and Lowery (1990), and Bails (1990) found TELs to be ineffective. These studies, however, are empirically weak. Abrams and Dougan along with Cox and Lowery use cross-sectional data. Bails does not adequately control for other factors that might influence government behavior (e.g. the business cycle).

Only one study has examined time-series data. Dougan (1988) examined time series data from 1960 to 1984 for 16 states that had TELs. In 7 of the 16 states, he found a significant and negative impact of TELs on government spending. But Dougan used only 25 years of data (1960–84), making it hard to be comfortable with his conclusions.

More recent studies have found evidence that supports the effectiveness of TELs in reducing the growth in government spending. Stansel (1994) looks at 18 states with TELS and compares state spending growth rates to the national average before and after the implementation of TELs. He finds state spending 0.8 percent above average before TEL passage and 2.9 percent below average after passage.[2] To see if the reductions in state spending are offset by increases in local spending, he also looks at combined state and local spending. As a result of TEL passage, combined state and local spending went from 2.3 percent above average to 1.2 percent below average. This indicates that reductions in state spending are offset to some degree by increased spending at the local level—that is, there is some shifting of spending to the local level when state spending is constrained.

Stansel's review of TELs suggests that the most effective TELs are written by voters, are constitutional rather than statutory, and are linked to spending rather than revenues. However, Stansel's analysis suffers from a problem common to earlier studies: it does not control for factors like regional recessions and unique state features that may bias the results.

The early findings that TELs are ineffective may be due to the fact that high-spending states are more likely to pass TELs, or because TELs may reflect a shift in voter preferences for less spending. In the latter case, it is not the TEL, but the change in voter preferences that causes a reduction in spending. In this case, TELs do not play

[2]He excludes Connecticut and North Carolina because the recent passage of their TELs resulted in insufficient data to do the analysis. Rhode Island and Nevada TELs only apply to the governors' proposed budget so they are also excluded. Alaska is not included even though it has a TEL, because its revenues are primarily related to oil production.

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a causal role in reducing spending. This TEL endogeneity issue may have a significant impact on statistical inference, biasing the results. Work by Reuben (1995) attempts to address this issue.

Rueben estimates a model of government spending that includes a dummy variable for the presence of a TEL.[3] Next, the same model is estimated using an instrumental variables for the TEL dummy variable to control for possible endogeneity. The key is to find an instrumental variable, correlated with the chances of passing a TEL, that captures changes in voter preferences and, at the same time, is uncorrelated with the level of revenues raised through the tax system. This would separate the effect of TELs from any changes in voter tastes.

Reuben uses citizen direct legislation laws (which allow citizens to directly propose and then vote on laws) that should be positively related to the passage of TELs, but unrelated to current expenditure levels.[4] Most of these direct legislation rules were passed early in this century, so their existence will not influence current spending but will increase the chance of TEL passage.

As in previous studies, Reuben's simple ordinary least squares results show a positive relationship between TELs and government spending—limits actually *increase* state spending. But when the model is estimated using instrumental variables, spending *declines* by 1.8 percent due to TELs. (Actually, state spending falls by more than 1.8 percent, but reductions in state spending are partially offset by higher spending at the local level; 1.8 percent is the net decrease.) These results suggest that failing to control for the endogeneity of TELs leads to biases in empirical estimation.

Poterba (1994) suggests that TELs may impact how a state adjusts its budget to unexpected negative economic shocks. Using data for the period from 1988 to 1992, he finds that states with TELs experience lower tax increases in the face of negative economic developments. A $1.00 increase in the budget deficit results in a $0.47 tax increase in TEL states. In non-TEL states, the increase is much higher—$1.03. TELs appear to have no impact on the size of spending reductions.[5]

[3]Reuben uses a model that explains state and local government spending with explanatory variables that include a measure of the tax burden of government, a demand for government variable, demographic variables, and business-cycle variables.

[4]Matsusaka (1995) looks at the impact of citizen initiatives rights on spending. He finds state spending to be 12 percent less and local spending 10 percent higher in initiative states. Also, initiative state taxes are 8 percent lower and user fees 7 percent higher. This implies that in states where citizens have initiative rights, they prefer spending to be more local and rely more on direct user fees over taxation for revenues.

[5]Poterba also finds that, in response to shocks, single-party states increase taxes and reduce spending more than states with split party control.

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Line-Item Veto

Most governors have some type of executive veto over state spending. Only 6 have all-or-nothing veto, 33 have line-item veto, and 11 have item-reduction veto power. In the all-or-nothing case, the governor must veto the entire budget (or a large portion) or nothing at all. Item vetoes are more flexible in that the governor can veto a particular item in the budget. In the item-reduction version, a governor has the flexibility to lower the level of funds without eliminating the entire item from the budget. If the governor likes a program, but thinks the allocation is too great, he or she can reduce funding to the program. In all these situations, the ability to sustain a veto is likely to have a large impact on the willingness of a governor to use veto power.

The effect of line-item veto power at the state level is particularly interesting to study as there has been considerable debate about giving the president this power to reduce pork barrel spending at the federal level. Recent legislation gives the president this power effective in 1997, but it will not be permanent. It will end in 2005.

Critics of the line-item veto argue it gives the governor too much power in the budget-making process. In addition, it can create a moral-hazard problem with respect to controlling government spending. The line-item veto shifts responsibility for cutting waste from the budget to the governor. As a result, the legislature may lose some of its fiscal discipline (Crain and Miller 1990).

Proponents argue that the line-item veto gives the governor much needed power to cut wasteful spending items from the budget. In this manner, spending is more likely to be consistent with the preferences of the median voter, rather than the spending level preferred by special interest groups representing a high-spending district. A factor that can influence the use of the line-item veto is the possibility that a legislature, with a large enough majority in the opposition party, can override a governor's veto. A veto is most likely to be used when the governor and legislature are of different parties and in situations where the governor is more likely to be able to sustain the veto (Holtz-Eakin 1988).

Studies by Rowley, Shughart, and Tollison (1986), Nice (1988) and Alm and Evers (1991) provide cross-sectional tests of the impact of the line-item veto on state spending. Generally, they find the presence of the line-item veto has little impact on spending growth. Controlling for differences in political parties between the governor and the legislature does not change the result.

Holtz-Eakin (1988) provides both cross-sectional and panel estimates of a median-voter government spending model for 48 states

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(excluding Alaska and Nebraska) for the period from 1965 to 1983. He is careful to control for situations where the political affiliation of the governor and the legislature differ. He also includes a measure that indicates that a governor is of a different party than the legislature, but has enough votes in the legislature to sustain a veto.

Holtz-Eakin's cross-sectional results are consistent with other studies in the literature, indicating that the power to veto legislation on a line-item basis does not reduce spending at the state level. Using panel data, he finds that the line-item veto reduces spending when two conditions hold: (1) the parties of the legislature and governor differ and (2) the governor can sustain a veto (the majority party does not have enough seats to overturn a veto). In cases where the governor has veto power and the ability to sustain the veto, Holtz-Eakin finds that Democratic governors tend to reduce current spending while Republican governors focus on reducing capital spending.

Carter and Schap (1990) argue that if the line-item veto increases executive power, then the existence of veto power should increase chances of reelection, election to national office, and campaign contributions. Their results show veto power does not significantly increase chances of reelection. They find governors with veto power are elected to national office *less* often. Campaign contributions are positively influenced by veto power, but not significantly. These results do not suggest the line-item veto is a particularly powerful political tool.

Crain and Miller (1990) provide some evidence the line-item veto influences spending. Looking at the growth in state spending between fiscal years 1983–84 and 1985–86, they find that, although the existence of a line-item veto does not influence spending, the more flexible item-reduction veto does reduce state spending growth. They carefully control for a large range of institutional factors that might impact spending. Also, since they use growth rates, their results do not suffer from the criticism that unobserved fixed-state effects are biasing their results.

Finally, Dearden and Husted (1993) try to determine if governors with the line-item veto end up with budgets relatively closer to the ones they propose. Rather than using total spending as the dependent variable, they use the percentage difference between actual state expenditures and the expenditure level proposed by the governor. Using a panel of data covering the years from 1983 to 1989, they find governors with a line-item veto end up with a level of expenditures closer to what they propose than do governors without veto power. The impact is stronger if the governor has a spending-reduction veto rather than a simple line-item veto, and when the governor is in a

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minority party that has sufficient presence in the state legislature to sustain a gubernatorial veto.

Balanced-Budget Requirements

Every U.S. state has a balanced-budget requirement except Vermont. The actual rules vary considerably from state to state. Only 44 states require the governor to submit a balanced budget at the start of the budget cycle. In 37 states, the legislature is required to pass a balanced budget. In 13 of those states, the government can legally run a budget deficit by simply carrying the deficit over to the next fiscal year. These are weak budget rules and are likely to be ineffective. In contrast, the remaining 24 states that require the legislature to pass a balanced budget prohibit deficit carryover. If a deficit develops during the year, it must be eliminated by cutting spending or raising taxes.[6]

In almost every case, the balanced-budget rule applies to the general fund or operating budget. Only 34 states apply these rules to special funds for which taxes are specifically earmarked. Fewer states have rules that constrain capital spending and trust funds (33 and 30 states, respectively).

Researchers have started investigating whether these rules influence the level of government spending, borrowing, and the size of deficits. Poterba's 1994 study (discussed earlier), found that, in response to a $100 unanticipated increase in the state deficit, states with strong anti-deficit rules reduced per capita spending by $44. In states with weak anti-deficit rules, the adjustment was only $17 per capita. In other words, states with strong balanced-budget rules adjusted faster to unexpected shocks.

Using an index to measure the stringency of budget rules, Von Hagen (1991) finds the ratio of nonguaranteed debt to guaranteed debt is higher in states with stringent rules on general fund deficits, suggesting a shift in borrowing to off-budget nonguaranteed debt. Since this type of borrowing is not covered by many balanced-budget rules, and does not require voter approval, it reflects an effort by politicians to work around such rules. Also, debt per capita is higher in states with weak budget rules, compared to states with strong rules.

The most complete examination of balanced-budget rules can be found in a paper by Bohn and Inman (1996). They construct a comprehensive deficit measure that includes the general budget and budgets

[6]It is possible to use gimmicks to eliminate the deficit. For example, budget administrators could postpone payments to eliminate some of the deficit. But these options are fairly limited.

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from five other funds—the capital fund, insurance trust fund, public employees retirement fund, rainy-day fund, and rollover funds.[7]

Using this comprehensive deficit measure, they estimate a model for 47 states covering the period 1970 to 1991. They control for business-cycle conditions in the state, the state's asset position, and the political parties of the governor and majority in the legislature. Bohn and Inman find that balance-budget rules do matter. Tight end-of-year rules (i.e., no carry-over provision) significantly reduce general fund deficits, while weak beginning-of-the-year rules do not. These tight limits increase general fund balances by $100 per capita. The larger surpluses appear to be the result of lower spending rather than higher taxes. Rainy-day reserve funds are also higher in states with tight rules.

Bohn and Inman find that enforcement of balanced-budget rules varies across states. It appears to be most effective when done from outside the legislature or executive branch. Constitutional constraints that require a super-majority (two-thirds of the legislature) to overrule are more effective than statutory rules. States with supreme court justices that are popularly elected, as opposed to appointment by the governor or election by the legislature, have smaller deficits. Reducing legislative and executive control over legal enforcement increases effectiveness.

Finally, Bohn and Inman question whether balanced-budget rules move states farther away from optimal tax policies. To minimize the excess burden of taxation, taxes should change as little as possible in response to economic fluctuations (Barro 1979). Taxes should follow a random walk, making it impossible to predict tax changes, which should be permanent. Such "tax smoothing" implies procyclical surpluses. But, by reducing short-run fiscal flexibility, balanced-budget rules may force states to increase taxes during periods of fiscal distress, making it harder to achieve an optimal tax.

To examine the effect of balanced-budget rules, they test the null hypothesis that tax revenues follow a random walk. Their results reject the random walk hypothesis, suggesting that balanced-budget rules limit the amount of tax smoothing in a state. This means that, from a policy perspective, the positive aspects of balanced-budget rules must be weighed against the deadweight losses incurred as a result of decreasing the efficiency of a state's tax policy.

Bohn and Inman also examine whether the sensitivity of state budgets to movements in the business cycle is affected by tight balanced-budget rules. For example, if balanced-budget rules reduce spending

[7]A rollover fund contains short-term debt held in anticipation of future repayments.

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on items such as unemployment compensation during recessions, budgetary cyclical sensitivity will decline. The results of Bohn and Inman's empirical tests are mixed. When they use income growth as a cyclical indicator, they find balanced-budget rules reduce the sensitivity of state budgets to movements in the business cycle. However, when unemployment is used as a cyclical indicator, they find that balanced-budget rules have no effect on budgetary cyclical sensitivity.

Alesina and Bayoumi (1996) make the point that policymakers should consider both the costs and benefits of budgetary rules. Using an index of the restrictiveness of state budgetary rules (this includes both balanced budget constraints and tax and expenditure limits), calculated by the Advisory Commission on Intergovernmental Relations, they find that budget restrictions, as measured by the index, are effective in controlling deficits. States with tighter budgetary rules have larger average surpluses and less variability in the budget over time.

On the cost side, they ask if increases in fiscal discipline resulting from strict budgetary rules come at the expense of fiscal flexibility and greater variability in state output. They find no relationship between tight budget restrictions and variability in state output. This finding suggests that state stabilization policy may be relatively unimportant. Also, although budget restrictions limit stabilization expenditures, which might raise state output in a recession, Alesina and Bayoumi suggest it also limits wasteful "pork barrel" spending that can increase budget variation.

Constraints on Debt

Von Hagen (1991) and Bunch (1991) examine the impact of debt limits on the composition and amount of state debt. Von Hagen does not find significant differences in debt per capita between states with and without limits. He also compares the frequency distributions of debt from limit and non-limit states. The distributions are significantly different with states with limits having a lower median.

Both Von Hagen and Bunch find that states that limit guaranteed debt issue relatively more nonguaranteed debt. This suggests that state governments use public authorities, which are not subject to the limit and taxpayer scrutiny, as a means to work around the limit. Public authorities issue nonguaranteed or revenue debt. Bennett and DiLorenzo (1982) find nonguaranteed debt, financed by revenue bonds, increase following the passage of a TEL.

What is interesting about these studies is that off-budget expenditures and the resulting debt are not subject to constitutional or

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statutory laws. Clearly, legislators have used off-budget agencies and revenue bonds as a means to work around debt and spending limits, resulting in a continued growth in government. However, Marlow and Joulfaian (1989) find that TELs have not increased off-budget, state and local expenditures. These results may differ from Bennett and DiLorenzo because they examine the issue using only cross-sectional data, while Bennett and DiLorenzo examine movements in nonguaranteed debt over time.

One reason that budgetary rules may have a modest impact is that financial markets limit state fiscal mismanagement. By adding a risk premium to the cost of excessive state borrowing, the market raises the cost and may discourage irresponsible budgetary behavior.

The way it works is that a high level of outstanding debt or rapid growth in debt increases the probability that a state will have trouble servicing its debt or even default. Under these circumstances, lenders will require higher interest rates to compensate for the extra risk they bear. As borrowing costs rise, states face incentives to reduce deficit spending and borrowing.

Goldstein and Woglom (1992) and Bayoumi, Goldstein, and Woglom (1995) test the market discipline model using data from the state bond market. Their models are estimated for 38 states using data from the 1981 to 1990 period. The models explain interest premiums on state bonds with fiscal policy variables like outstanding debt, budget deficit, and growth in debt. Bond ratings, the state of the business cycle (measured by the state unemployment rate or year dummy variables), the state tax structure, and a measure of constitutional controls on state borrowing are also included in the empirical models. The borrowing control limit index ranges from a low of zero for Vermont, which has no limits, to an upper bound of 10 for 26 states.[8]

The models fit the data reasonably well. While estimation methods and model specification differ in the two papers, many of the explanatory variables are significant with the expected sign. For our purposes, the most interesting result is that the fiscal controls variable, which measures institutional constraints on budget deficits and borrowing, is significant at the 1 percent level. The estimated coefficient suggests that states with fiscal controls have a reduction in interest costs by as much as 50 basis points. This result indicates that lenders in U.S. capital markets believe that lending to states with fiscal constraints is

[8]They measure budget restrictions using an index calculated by the Advisory Commission on Intergovernmental Relations. The index ranges from 0 to 10, where a value of 10 is most stringent.

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less risky. Strict budget rules result in more controlled spending and less borrowing, reducing the cost of financing to states.

Eichengreen (1992) uses a different specification to test whether state debt and budget limits influence state bond yields. Using U.S. state data for 1985 to 1989, Eichengreen finds debt limits do not influence yields. However, budget provisions that limit carry-overs and stringent balanced-budget rules do appear to lower yields. He also finds these rules reduce state per capita debt and increase the state per capita general fund surplus.

Conclusion

Based on the studies cited here, it is clear that budgetary rules impact the tax and spend behavior of politicians. Limits on taxation and spending, the power of governors to veto and reduce state spending on a line-by-line basis, and balanced-budget rules all have the intended effect, reducing state spending, taxes, and debt.

Citizens interested in establishing budgetary constraints should follow the guidelines gleaned from the empirical results of the studies reviewed in this paper:

- Limit the ability of politicians to work around constitutional tax and expenditure limitations by including restrictions on nonguaranteed borrowing and off-budget spending.
- Try to broaden the governor's power by including an expenditure-reduction veto, which is more effective than a simple line-item veto. The line-item veto is only useful when a governor's political party differs from the majority in the legislature, but has sufficient votes to keep the majority from overriding a veto.
- Do not allow deficits to be carried forward to the next fiscal year. Balanced-budget rules work best to limit spending when this constraint holds.

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Medicare's Origin: The Economics and Politics of Dependency

Charlotte Twight

Americans now stand on the brink of transferring massive additional powers over their personal health care to the federal government. Politico-economic techniques used to pass the original Medicare legislation in 1965 are being employed again in the 1990s to secure passage of expansive new health care measures despite resistance of the public at large. Passage in 1996 of the Health Insurance Portability and Accountability Act—whose less publicized provisions criminalize aspects of the practice of medicine and jeopardize the privacy of doctor-patient relations through a compulsory nationwide electronic database—was achieved largely through techniques similar to those used to pass Medicare. Correct interpretation of Medicare's politico-economic history is therefore central to understanding ongoing attempts to enlarge the federal government's role in the market for medical care.

This article analyzes the nature and timing of Medicare's origin. My objective is not only to chronicle Medicare's evolution but to evaluate its history in a consistent theoretical framework. Based on thousands of pages of original congressional documents—House and Senate hearings, House and Senate reports, the Congressional Record, and other sources cited below—I show that Medicare's passage was achieved through government officials' deliberate decisions to restructure political transaction costs to overcome the widespread public opposition which had prevented passage of such bills for more than 50 years. History shows that Medicare did not and could not achieve passage without the misrepresentation, cost concealment, tying, and incrementalism to which its supporters ultimately resorted.

The 20th century has seen a transformation of unprecedented magnitude in the provision of U.S. health care. Governments now exert

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significant control over health care markets, and—despite the 1996 act's commitment to a limited federal experiment with individual "Medical Savings Accounts"—federal control is likely to grow. Medicare dramatically influenced this transformation, making the federal government the biggest purchaser of health care services and a primary determinant of the type, quality, and cost of health care services in major segments of the U.S. health care market. For decades Medicare payroll taxes have required low-income workers to subsidize medical care for more affluent retirees, while individuals as consumers of medical services increasingly have been constrained by a web of government controls.

Like the Social Security Act that it amended, the 1965 Medicare program was ostensibly a vehicle for reducing dependency in old age. In reality, both laws were dependency-shifting rather than dependency-reducing: mandated dependence of the elderly on the federal government and taxpayers replaced potential dependence on family and charity. This paper investigates how and why Medicare became law and considers what the observed pattern of institutional change implies for America's future.

Political Transaction Costs: A Theoretical Framework

Diverse theories of institutional change resonate strongly with U.S. political experience in the 20th century—theories based on interest-group politics, crisis, rent seeking, credit claiming, blame avoidance, and cost concealment, to name but a few.[1] With the advent of public choice economics, scholars have taken an ever closer look at the often self-interested motivations of political actors. Much of my work in recent years has involved developing and testing a theory of government manipulation of ("constitutional-level") political transaction costs. As explained below, it is a theory of government officials' rent-seeking by means of political transaction-cost augmentation. While no theory supplies the only viable explanation of politics and institutional change, transaction-cost augmentation theory provides a useful predictive lens through which to perceive how and why institutions change. It is a particularly useful lens in the case of the evolution of Medicare.

The central idea behind the theory is that government officeholders, as individuals, have strong incentives to alter important political transaction costs facing the public and facing others in government in

[1]See, for example, Weaver (1986), Mayhew (1974), Tullock (1967), Higgs (1985, 1987, 1988).

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order to secure more of what they want with less resistance. As economists use the term, transaction costs are costs to individuals of negotiating and enforcing market exchange agreements, including information costs, negotiation costs, enforcement costs, and the like. Accordingly, I define political transaction costs—in particular, constitutional-level political transaction costs—as the costs to individuals of negotiating and enforcing collective political agreements that alter the role and scope of government.[2] Constitutional-level political transaction costs thus denote not only information costs, but also what I term "political agreement and enforcement costs." Whereas political information costs influence people's perceptions of the costs and benefits of government authority in a given sphere, political agreement and enforcement costs alter the costs of acting upon those perceptions. One might have perfect information and yet be deterred from taking political action if these other costs of taking political action were increased.

It is clear that government officials often take deliberate steps to increase the information costs to private citizens (and to each other) of accurately perceiving measures that change the scope of government authority. For instance, titles of bills often imply laudable objectives inconsistent with legislation's full impact—as exemplified recently by the Health Insurance Portability and Accountability Act, a significant part of which jeopardizes private medical practice as well as the privacy of people's personal medical records. In such a case, how many see beyond the language of "portability" and "accountability"? All manner of political misrepresentation falls into the information cost manipulation category.

It is equally clear that government officials often take deliberate steps to increase agreement and enforcement costs to private citizens of taking collective political action on measures that change the scope of government authority. For instance, when government officials spread the costs of a measure while concentrating its benefits, when they pursue incremental strategies for political change, when they tie controversial measures to more popular legislative proposals, when they differentially burden third political parties, and when they alter the locus of decisionmaking authority so as to shift the transaction-cost burden of changing the government's role, they increase the costs

[2]In what follows, when I refer to political transaction costs, I mean "constitutional-level" political transaction costs.

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to private citizens of taking collective action to resist proposed changes in government authority.[3]

Deliberate government actions that increase constitutional-level political transaction costs thus drive a wedge between people's preferences and the political expression of those preferences. The theory's predictive power, however, lies in specifying circumstances that encourage government officials to approve such transaction-cost-increasing measures. In previous work I have identified the following variables as positively associated with an individual government official's decision to support a measure that increases the cost to the public (or to other government officials) of understanding or taking political action on a measure that alters the scope of government authority. A government officeholder's decision to support a transaction-cost-increasing measure is posited to be a positive function of (1) the political job security and perquisites promised by the measure; (2) third-party payoffs to the decisionmaker; (3) executive support for the measure; (4) party support for the measure; (5) the measure's complexity; (6) its perceived importance to constituents; and (7) the existence of an appealing rationale for the measure.[4] Support is posited to be a negative function of publicity accorded the transaction-cost-increasing features of the measure. Ideology and time also are expected to play important roles. For instance, *ceteris paribus*, a congressman's ideology is expected to encourage him to support measures that increase the transaction costs to the public of resisting changes in the scope of government authority that are congenial to his ideology. The influence of time's passage is less predictable, since it facilitates both wider dissemination of information and entrenchment of beneficiary interest groups, disparate impacts whose relative magnitudes cannot be known *ex ante*.[5]

[3]A classic example of the latter is the historical increase in the power of the U.S. Supreme Court to expand the scope of government authority in ways that otherwise would have required amendment of the U.S. Constitution.

[4]The complexity and appealing rationale variables require further comment. An issue's complexity may be either unavoidable or itself a product of transaction-cost augmentation. Similarly, an appealing rationale may be either false or true. In either case, the direction of impact on an officeholder's decision regarding a transaction-cost-increasing measure is as described in the text. Issue complexity, like the existence of an appealing rationale, makes it harder for citizens to perceive transaction-cost-increasing features of policy proposals. Moreover, both of these conditions allow politicians greater room to credibly claim to have made a "mistake" if negative public reaction to the measure's transaction-cost-increasing features does materialize.

[5]More detailed treatment of transaction-cost augmentation theory is available elsewhere (Twight 1983, 1988, 1994).

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Political transaction-cost augmentation proved to be the lifeblood of the 1965 Medicare legislation. Misrepresentation, cost concealment, tying, incrementalism, and procedural stratagems all were used by government officials to raise the transaction costs to voters of resisting Medicare. As explained below, in 1965 for the first time all of the determinants enumerated in the preceding paragraph favored pro-Medicare transaction-cost augmentation. In that year, Congress relied heavily on such strategies to pass a Medicare bill laden with transaction-cost-increasing features. Consider first the Medicare idea's early history in the United States.

Compulsory Health Insurance Proposals before 1964

For more than 50 years before the 1965 enactment of Medicare, the American people repeatedly rejected the idea of government-mandated health insurance. Yet advocates of such federal power inside and outside of government did not take no for an answer. Year after year they kept coming back—pursuing incremental strategies, misrepresenting their proposals, even distributing propaganda paid for with government money in apparent violation of existing law. In the end Medicare's passage was anything but a spontaneous societal embrace of one of the pillars of President Lyndon Johnson's "Great Society."

The federal government's involvement with this issue began in earnest in 1934.[6] In that year President Franklin Roosevelt established the Committee on Economic Security (CES) and charged it with drafting a Social Security bill. Although the original CES report on Social Security stated with Roosevelt's approval that a "health insurance plan would be forthcoming," the CES statement caused such a stir that Roosevelt decided to postpone the health insurance issue, fearing that it jeopardized passage of the Social Security bill (Corning 1969: 38). Accordingly, the provision in the original Social Security bill proposing a "Social Insurance Board" and authorizing study of

[6]Widespread interest in compulsory national health insurance had been inspired by Bismarck's 1883 program in Germany, a program rapidly emulated by other nations. In 1906 activists formed the American Association for Labor Legislation (AALL), an organization that would take up the cause in this country. Centralized control over health care was much in the air as Britain adopted a compulsory national health system in 1911. For discussion of the history of federal treatment of health care issues from 1793 forward, beginning with federal reaction to the early yellow fever epidemics and debates over federal quarantine authority, see Chapman and Talmadge (1970). See Wasley (1992: 49–50, 55–8) regarding the federal government's role in stimulating employer-provided, first-dollar coverage health care as well as its efforts (along with those of state governments) to benefit Blue Cross to the detriment of other insurers.

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health insurance was changed so as to delete all reference to health and rechristen the board as the "Social Security Board" (Chapman and Talmadge 1970: 342). President Roosevelt had decided that "health insurance should not be injected into the debate at that point, nor should the final report on health be made public as long as the social security bill was still in the legislative mill." Indeed, as of 1969 the final CES report on health still had not been made public (Corning 1969: 40, n. 17).

Governmental advocacy of compulsory health insurance was in no way hindered by these developments: government officials proceeded as if the original statutory language had been retained. The Social Security Act signed into law on August 14, 1935, empowered the Social Security Board (SSB) to study "related" areas, and on August 15, 1935, Roosevelt appointed an Interdepartmental Committee to Coordinate Health and Welfare Activities to pursue the health insurance issue. Then in 1936 the SSB hired Isidore S. Falk, a key figure in the subsequent development of Medicare, to work on health insurance.[7] The following year the Interdepartmental Committee established a "Technical Committee on Medical Care" whose members decided in a private conference that "it would be desirable to formulate a comprehensive National Health Program." The Technical Committee published its report in February 1938, soon thereafter sponsoring a "climate-building" three-day National Health Conference to promote the issue (Corning 1969: 45–6). Resultant Interdepartmental Committee recommendations included a "general program of medical care, paid for either through general taxation or social insurance contributions," as well as federal support for hospital expansion, disability insurance, public health services (including maternal and child health), and state programs for the "medically needy" (Poen 1979: 19).

With the ground thus prepared, health care legislation was introduced in virtually every session of Congress from 1939 forward.[8] Senator Robert Wagner (D., N.Y.) introduced a bill in 1939 (S. 1620) incorporating the recommendations of the National Health Conference.

[7]Falk had been associated with the Committee on Economic Security and was a strong advocate of national health insurance. Poen (1979: 17) wrote of Falk: "At a March 1934 meeting of the Milbank Fund, Isidore Falk outlined a plan for national health insurance, and Harry Hopkins told the gathering, 'You aren't going to get health insurance if you expect people to do it voluntarily. I am convinced that by one bold stroke we could carry the American people along not only for health insurance but also for unemployment insurance. I think it could be done in the next eighteen months.' "

[8]Regarding Medicare's early legislative history, see Corning (1969), Feingold (1966: 96–156), Marmor (1970, 1973), Myers (1970), Poen (1979), Anderson (1966), and Derthick (1979: 316–38).

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Beginning in 1943 a series of bills, known as the Wagner-Murray-Dingell bills in recognition of sponsors Senator Robert F. Wagner (D., N.Y.), Senator James Murray (D., Mont.), and Rep. John Dingell (D., Mich.), explicitly sought to establish universal compulsory national health insurance at the federal level, insurance that "covered virtually all kinds of care for virtually the whole work force and their dependents" (Derthick 1979: 318). Having developed the 1943 bill for Senator Wagner, the Social Security Board in 1944 specifically recommended to Congress that compulsory national health insurance be made part of the Social Security system.[9] As Derthick (1979: 317) stated, "Nowhere is the aggressiveness of social security program executives better demonstrated than in these early campaigns for national health insurance."

Legislative efforts in the 1930s and 1940s went nowhere. The American Medical Association (AMA) strongly opposed compulsory national health insurance, denouncing it as socialized medicine and mounting costly efforts to defeat it.[10] President Roosevelt withheld his active support. Opinion polls indicated strong public opposition, with 76.3 percent of the public in a 1942 *Fortune* poll saying that the government should not provide free medical care (Cantril 1951: 440).

Nonetheless, advocates of compulsory national health insurance carried out an extensive media campaign to sway public opinion on the issue (Poen 1979: 42–45, 50). Governmental influence was sometimes overt, as in the publication of an important article in the December 1944 issue of *Fortune* magazine:

> At first, the magazine had planned to conclude the story with a judgment adverse to the W-M-D [Wagner-Murray-Dingell] bill, but thanks to [Senator] Wagner's tactful protest and the information supplied by [SSB official] Falk, the finished article portrayed a picture decidedly favorable to the proposed health program [Poen 1979: 45].

When Harry Truman became president in 1945, health insurance advocates gained a more committed if less charismatic ally in the executive branch. In November 1945 Truman submitted to Congress the first ever presidential message devoted exclusively to health care (Poen 1979: 64).

Developments in 1950–51 proved pivotal to eventual passage of Medicare. In the off-year 1950 elections, incumbents who had supported compulsory national health insurance were defeated. Moreover, while retaining control of Congress, Democrats suffered

[9]The 1943 bill was developed by Social Security Board (SSB) chairman Arthur Altmeyer, his assistant Wilbur Cohen, and SSB research director Isidore Falk (Poen 1979: 33–4).

[10]The AMA's history and practices are discussed in Goodman (1980).

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net losses in the House and Senate. Wilbur Cohen and Isidore Falk, key Social Security Administration (SSA) officials instrumental in the push for Social Security and government health insurance since the early days, came to believe that universal compulsory health insurance could not be passed. With this realization came the idea of restricting their proposal to the elderly, an idea first suggested by Dr. Thomas Parran of the Public Health Service in 1937 and by Merrill G. Murray (Social Security Administration official) in 1944 (Corning 1969: 71; Marmor 1970, 1973: 14). When Federal Security Administrator Oscar Ewing independently developed the same concept in December 1950 and began to explore the idea in the spring of 1951, Cohen and Falk already had developed the materials he needed (Poen 1979: 189–91).

Recrafting the proposal as compulsory federal health insurance for the aged thus reflected a deliberate decision to use an incremental strategy, initially targeting the group of recipients who would evoke the greatest sympathy with the public. However, despite this foot-in-the-door approach, resistance continued. With Eisenhower's election in 1952, Medicare advocates sought to keep the issue alive by continuing to introduce bills in every session of Congress (Cohen and Ball 1965: 3). Their proposals invariably encountered strong opposition from the AMA and the medical community, remaining unsuccessful even with coverage limited to hospital and nursing home care for the elderly. How to proceed?

Again, incrementalism was part of the answer. Disability coverage was added to Social Security in 1956, a step Martha Derthick (1979: 319) viewed as an essential part of the incremental process leading to passage of Medicare, "a necessary prelude." Describing the evolution of the disability program, Derthick noted that "incremental change . . . has less potential for generating conflict than change that involves innovation in principle" causing program executives, "even when undertaking an innovation in principle," to try "to cut and clothe it in a fashion that made it seem merely incremental" (Derthick 1979: 314).

With disability coverage in place, in 1957 the AFL-CIO recommitted itself to the fight for compulsory health insurance. Accordingly, a group of long-time Medicare advocates—Wilbur Cohen, then a professor at the University of Michigan; Isidore Falk, then working as a consultant for the United Mine Workers; Robert Ball, long-time SSA official; and Nelson Cruikshank, director of the AFL-CIO's Department of Social Security—formulated a bill proposing hospital, surgical, and nursing home benefits for Social Security recipients (Poen 1979: 217; Derthick 1979: 320–21; Marmor 1970, 1973: 30). They persuaded Rep. Aime J. Forand (D., R.I.) to introduce the bill:

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hearings were held in 1958–59, and the Forand bill was rejected by the House Ways and Means Committee in 1959. Then in 1960 Congress passed the Kerr-Mills bill (P.L. 86-778) to provide medical aid for the aged poor, establishing a needs-based program of Medical Assistance for the Aged (MAA). Championed by House Ways and Means Committee chairman Wilbur Mills (D., Ark.) and Senator Robert Kerr (D., Okla.) and drafted by Cohen at their request, the Kerr-Mills approach was a preemptive effort by those who hoped that providing medical care for the aged poor would deflect broader efforts to inject government into the market for medical care.

Their hope was misplaced. No sooner had Kerr-Mills been adopted than renewed efforts were made to craft a politically viable bill to provide compulsory health care insurance for the aged. In 1961 and again in 1963 Rep. Cecil King (D., Calif.) and Senator Clinton Anderson (D., N.M.) introduced measures patterned on the Forand bill (the King-Anderson bills). A competing approach that would have permitted individuals to choose comparable private insurance coverage was offered in 1962 by Senator Clinton Anderson (D., N.M.), Senator Jacob Javits (D., N.Y.), and numerous cosponsors (the Anderson-Javits bill).[11] Although proposed coverage was restricted primarily to hospital care and some nursing services in the effort to find a thread that would pass through the eye of the legislative needle, still the bills did not move forward. Despite President John F. Kennedy's support for Medicare in 1960 and thereafter, the political calculus did not change until 1964.

Medicare 1964–65: Reshaping Political Transaction Costs

By 1964 sustained efforts to legislate compulsory health insurance at the national level had continued for three decades. For 30 years since the Committee on Economic Security first endorsed the idea, Congress and the public repeatedly rejected it. In these circumstances, how could a Medicare bill possibly be passed in 1965? First, as shown below, the 1965 bill and the procedures employed in its passage were rife with transaction-cost augmentation, allowing government officials who supported it to impede public opposition. Second, consistent with the theory, concurrent changes in the variables posited to be determinants of this behavior more strongly encouraged legislators to

[11]For a detailed summary of the differences between these bills, see Feingold (1966: 102, 115, 122–23, 125).

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support such transaction-cost-increasing measures on the Medicare issue than at any previous time in U.S. history.

Politically, what changed in 1964 was the resounding victory by Democrats in the general elections in November. Many perceived the election of Lyndon B. Johnson as an endorsement of compulsory national health insurance and other social programs regarded as pillars of his personal vision of the "Great Society." Congress was heavily in the hands of the Democrats. Moreover, a Gallup poll released on January 3, 1965, showed that efforts to sway public opinion on the national health insurance issue had been at least superficially successful: 63 percent of respondents now approved of the idea of a "compulsory medical insurance program covering hospital and nursing home care for the elderly . . . financed out of increased social security taxes"—even though 48 percent of those interviewed still did not know why the AMA opposed the program[12] (Gallup 1972, Vol. 3: 1915).

Political and ideological winds had shifted, nursed by the incremental politics of preceding years. But they had not shifted enough to procure compulsory health insurance for Social Security beneficiaries without deploying a full arsenal of transaction-cost augmenting stratagems to deflect and silence the opposition.

Transaction-Cost Augmentation and the 1965 Medicare Bill

The scope of transaction-cost augmentation used in designing and passing what came to be known as the 1965 Medicare bill defies brief description. We have seen the incrementalism that set the stage for the events of 1964–65. In 1965 transaction-cost augmentation took both of the general forms discussed earlier: raising information costs facing political decisionmakers and raising their costs of taking political action to resist the Medicare proposal.

[12]Consistent with the political transaction-cost augmentation described in this paper, three trends are evident in relevant polls despite variations in pollsters' questions. First, public awareness of the existence of various statutory proposals increased over time [for example, changing from the 63 percent who reported they hadn't heard of Truman's health insurance plan (the Wagner-Dingell-Murray bill) in April 1946, to the 34 percent who hadn't heard of it by December 1949]. Second, public resistance to the idea of government-provided health care benefits decreased (contrast the 76.3 percent who said in September 1942 that government should *not* provide free medical care to the 63 percent who approved of targeted compulsory medical insurance in 1965). Third, as noted in the accompanying text, even in 1965 most people continued to be ill-informed about issues surrounding the substantive provisions of the proposed measures. As late as 1962, although 81 percent reported they had heard of the Kennedy administration's Medicare plan, only approximately 41 percent of all respondents knew how it would be paid for, and only 9 percent knew who would be covered. See Gallup (1972, Vol. 1: 578; Vol. 2: 886; Vol. 3: 1781); Cantril (1952: 440, 443). Regarding polls conducted by members of Congress, see Skidmore (1970: 156–9); U.S. House Hearings (1963–64: 419).

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Manipulation of Political Information Costs. Government officials misled the public regarding the content of the bill. The Johnson administration's 1965 Social Security amendment bills, which began the year as H.R. 1 and S. 1, reflected the general approach contained in the King-Anderson bills introduced in 1961 and 1963. The 1965 bill proposed compulsory hospital insurance financed through the Social Security payroll tax, payable to persons over 65 years of age.[13] After a small deductible, hospital bills would be covered for 60 days. Ancillary coverage was to be provided for 60 days of nursing home care. Not covered were physicians' services outside the hospital, catastrophic illness that lasted more than 60 days, and therapeutic drugs.

The gulf between what the public thought and what was actually in the bill was enormous. The most pressing rationale for compulsory health insurance continually put forward by government officials and echoed by the public was the specter that responsible older people could be ruined financially by catastrophic illness. *Yet neither the 1963 nor the 1965 proposal provided coverage for catastrophic illness.* During the 1965 Senate Finance Committee hearings, Chairman Russell Long (D., La.) asked HEW Secretary Anthony Celebrezze, whose department had written the bill, "Why do you leave out the real catastrophes, the catastrophic illnesses?" (U.S. Senate Hearings 1965: 182). When Celebrezze replied that it was "not intended for those that are going to stay in institutions year-in and year-out," Senator Long countered: "Well, in arguing for your plan you say let's not strip poor old grandma of the last dress she has and of her home and what little resources she has and you bring us a plan that does exactly that unless she gets well in 60 days."

Celebrezze concurred, stating that means-tested public assistance would provide "additional help" (U.S. Senate Hearings 1965: 182–83). Long added that "Almost everybody I know of who comes in and says we ought to have medicare picks out the very kind of cases that you and I are talking about where a person is sick for a lot longer than 60 days and needs a lot more hospitalization" (U.S. Senate Hearings 1965: 184).[14] Yet the very element that

[13]Coverage included those who either were eligible for Social Security benefits, eligible for railroad retirement benefits, or reached age 65 in 1967 or later and met certain OASI work requirements before reaching age 65 even though not eligible for social security benefits. See Feingold (1966: 102, 115, 122–23, 125, 139).

[14]For discussion of the Medicare Catastrophic Coverage Act passed by Congress in 1988 and repealed in 1989, see Moon (1990).

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government officials continued to cite to win public support for Medicare was deliberately omitted from the administration's bills.

Despite their limited coverage, the bills came to be known as "Medicare," a term coined by a reporter to describe a previously established comprehensive health care program for military dependents. Many people therefore assumed that the bills before Congress would cover all forms of medical care, including outpatient physician fees and extended illnesses. When Rep. Albert Ullman (D., Ore.) cited allegations that the "public is somehow being hoodwinked" and "being misled" and asked HEW's Wilbur Cohen about the degree to which the public misunderstood the program, Cohen stated that "we do recognize this problem and I think it has been complicated by the use of the term 'medicare' which is an erroneous term when applied to this program" (U.S. House Hearings 1965: 104). Although government officials sometimes expressed dismay about this public misimpression, the misinformation nonetheless fueled support for passage of a bill they strongly supported.

A central rationale offered to the public for the bills that became Medicare was that they would enable people to "avoid dependence" in old age. In fact it was a bogus rationale that served as a key form of transaction-cost augmentation used to secure the bill's passage. That this rationale was not believed by the bills' authors in HEW is clearly indicated by Celebrezze's acknowledgments above regarding the omission of coverage for catastrophic illness. Nonetheless, government officials' repeated assertions that Medicare would "avoid dependence" made it more difficult for voters to understand that dependence in old age would not be forestalled by these measures, thereby diminishing resistance to the bills.

The appealing rationale of "avoiding dependence" provided a fig leaf for all manner of practical politics. Indeed, this form of transaction-cost manipulation hid one of the underlying political motives for the legislation: the desire of adult children to avoid the responsibility for their elderly parents. As Marmor (1970, 1973: 17) put it, "Strategists expected support from families burdened by the requirement, moral or legal, to assume the medical debts of their aged relatives." When Senator Clinton Anderson (D., N.M.) asked Celebrezze, "Isn't it true that younger persons would have lifted a heavy financial burden sometimes as a result of taking care of the aged in their family?" Celebrezze agreed (U.S. Senate Hearings 1965: 122). Warning that soon after enactment the public would discover the actual benefits to be much less than expected,

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Senator Allen Ellender (D., La.) stated on the Senate floor that "many sons and daughters whose mothers and fathers are growing old are of the belief that under the pending bill they will be able to get the Government to take care of their older parents, in the event they become ill for long periods of time" (*U.S. Cong. Rec.-Senate* 9 July 1965: 16072). The political undercurrent was that the "avoiding dependency" rationale gave a respectable gloss to adult children's desire not to support their aging parents which could be counted on to buttress political support for the Medicare measures.

Another important underpinning of the "avoiding dependency" rationale was the widely trumpeted portrait of elderly Americans as an impoverished group whose plight made them a sympathetic object of tax-supported medical insurance. Misrepresentation of the financial condition of the elderly helped to paint this portrait, as government officials advocating Medicare repeatedly cited statistics showing lower incomes received by the elderly in comparison with other age groups. Yet the income statistics by themselves were misleading because they did not include asset ownership, and the elderly as a group had more substantial assets than other segments of the populace. Rep. Thomas B. Curtis (R., Mo.) repeatedly challenged HEW officials regarding the "incompleteness of the income statistic," noting that "just as they have relatively low incomes as a group because they are on retirement, so they have more wealth than any other age group" since "they have been saving longer" (U.S. House Hearings 1963–64: 96).

The pro-Medicare pitch was that this presumptively deserving and financially precarious group should receive medical benefits without regard to need in order to protect elderly persons from the indignity of a means test. However, data submitted for the record from a 1960 University of Michigan study showed that "87 percent of all spending units headed by persons aged 65 or older" had assets whose median value matched asset ownership of people aged 45–64 and exceeded the asset ownership of people under age 45 (U.S. House Hearings 1963–64: 242–43). While HEW Secretary Celebrezze waxed eloquent about the necessity to furnish protection "as a right and in a way which fully safeguards the dignity and independence of our older people," Rep. Curtis questioned whether it was appropriate to "change the basic system" when 80 to 85 percent of the aged were able to take care of themselves under the existing system, recommending instead that we "direct our attention to the problems of the 15 percent, rather than this

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compulsory program that would cover everybody" (U.S. House Hearings 1963–64: 31, 392).

Some in Congress clearly recognized that one effect of the proposed program was to require the working poor to support the retired rich, as when Senator Long (D., La.) asked, "Why should we pay the medical bill of a man who has an income of $100,000 a year or a million dollars a year of income?" (*U.S. Cong. Rec.-Senate* 9 July 1965: 16096). Nonetheless, the predominant political motif was misleading allusion to the financial plight of the elderly, what Rep. James B. Utt (R., Calif.) called the false assumption "that everyone over 65 is a pauper and everyone under 65 is rolling in wealth" (*U.S. Cong. Rec.-House* 8 April 1965: 7389).

A major obstacle to Medicare legislation was widespread fear that compulsory federal insurance would result in federal control over medicine and over doctor-patient relationships. To counter this fear, the bill's authors drafted a provision specifically disavowing such control, the same strategy used to secure passage of public education bills in 1958 and 1965 (Twight 1996). Questioned about whether the 1964 bill represented socialism, Celebrezze directly addressed the issue of control, stating: "There is nothing in this bill which tells a doctor whom to treat or when to treat him. . . . There is nothing in this bill by which the Government would control the hospital, and as I understand socialism, it is Government control and operation of facilities. . . . It is merely a method of financing hospital care, and that is all" (U.S. House Hearings 1963–64: 50). He added,

> We are a paying agency and I don't see where you get any control of any kind out of that. Naturally, . . . there will be minimum requirements like these which are required now under Blue Cross. I see no evidence where this would lead to control over the doctors [U.S. House Hearings 1963–64: 54].

The AMA had a different view of the power of the federal purse. AMA President-Elect Dr. Norman A. Welch testified that "It is axiomatic . . . that *control follows money* when the Government steps in" (U.S. House Hearings 1963–64: 652; emphasis added). Citing the 1942 case of *Wickard v. Filburn*, Dr. Welch quoted the U.S. Supreme Court's statement that " 'It is hardly lack of due process for the Government to regulate that which it subsidizes' " (317 U.S. 111 at 131, 63 S.Ct. 82, 1942). More concretely illustrating such regulation and control, Dr. Austin Smith and Dr. Theodore G. Klumpp testified on behalf of the Pharmaceutical Manufacturers Association that, of the 200 most commonly prescribed drugs in the United States in 1964, 91 would not be covered by the revised 1965 Medicare bill

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(described below), in effect telling doctors that they could use "only these tools and not the others" to treat disease (U.S. Senate Hearings 1965: 767–8).

In the 1965 House hearings, Rep. Wilbur Mills (D., Ark.) put the control issue clearly. First he quoted the bill's provision that "Nothing in this title shall be construed to authorize any Federal officer or employee to exercise any supervision or control over the practice of medicine or the manner in which medical services are provided." Then he quoted other language in the bill specifying that amounts paid by the government to "any provider of services" under the bill "shall be the *reasonable cost* of such services, *as determined in accordance with regulations* establishing the method or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, services, and agencies." Mills concluded that "In spite of what we say here the Secretary has to get into some kind of an agreement with hospitals or hospital [sic] as to what the reasonable costs of taking care of a patient are" (U.S. House Hearings 1965: 136, 139, 142; emphasis added). Exactly so.

Rep. Curtis (R., Mo.) was even more outspoken about the control-creating effects of the agreements that would govern the relationship between the government and the hospitals, which he described as putting the federal government and HEW "into the business of making final determinations as to whether these charges are reasonable and whether these services are the kinds that are to be covered." He continued,

> We must recognize that this is the heart of this bill. . . . This is the way the HEW says to the hospitals, "Yes; this is what will be done." I am glad to have these words in the beginning of the bill saying that there is no Federal interference, and that there will be free choice of the patients guaranteed. But this is not the real test [U.S. House Hearings 1965: 308].

Nonetheless, the ostensible disavowal of control allayed public fears and thus increased the costs to private citizens of fully understanding the likely impact of the bill.

HEW also raised information costs to the public by engaging in lobbying practices of questionable legality. Citing HEW's pamphlet entitled "Health Insurance, Why We Need It," Rep. Curtis (R., Mo.) charged that HEW's use of public funds to prepare and distribute the pamphlet was "undermining the very process of representative government" (U.S. House Hearings 1963–64: 271). Since "those who disagree" had "no opportunity to present their side or their arguments about it," the pamphlet amounted to "propaganda and lobbying" in Curtis's view (U.S. House Hearings 1963–64: 79). Senator Karl E.

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Mundt (R., S.D.) further alleged that HEW had used public funds to carry out "deliberate sabotage" of the needs-based Kerr-Mills legislation passed in 1960 in order to stimulate support for the King-Anderson compulsory hospital insurance. Citing specific examples from his home state—including an HEW workshop conference on April 6, 1962, that "was open only to persons who opposed Kerr-Mills and supported King-Anderson"—Mundt described "public servants, paid with public funds, traveling at public expense, charged with administering a Federal law, going about the country trying to destroy public confidence in a law enacted by this Congress" (U.S. House Hearings 1963–64: 259–60).

Moreover, the method of financing the proposed medical insurance concealed its present and future cost to private citizens, further diminishing resistance to Medicare. It was to be piggy-backed on the Social Security payroll tax, with the additional payroll tax nominally split between employer and employee. As with the OASDI (Old Age, Survivors, and Disability Insurance) portion of the payroll tax, the nominal splitting of the Medicare tax would have no economic effect other than to hide the full cost from the worker (Browning 1975). Yet the director of the Bureau of the Budget, economist Kermit Gordon, testified that he didn't know the "ultimate incidence of a payroll tax," hadn't discussed it with HEW officials, and "[didn't] share [the] view that the payroll tax constitutes a significant deterrent to the employment of labor and stimulus to the substitution of capital for labor" (U.S. House Hearings 1965: 811, 813). Mandated employer withholding of payroll taxes from workers' paychecks likewise would increase the cost to workers of perceiving the magnitude of Medicare taxes paid (Twight 1995). The payroll taxes collected were to be put in a "trust fund" that was "separate" from the OASDI Social Security trust fund. People were told that during their working years they would be paying for "insurance" to defray the costs of illnesses in their old age. Supporters of Medicare repeatedly downplayed the regressivity of payroll taxes. In their view the taxes were not even taxes: according to government officials, they represented an "opportunity" to make "contributions" (U.S. House Hearings 1963–64: 67). In short, all the familiar lies and misrepresentations honed so well in the passage of the 1935 Social Security Act (Twight 1993) were trotted out again.

They worked just as well the second time. People believed the oft-repeated myth about "splitting" the proposed additional taxes. And, despite protestations from some congressmen, many voters did not understand that, far from putting funds into a paid-up insurance policy, they would be taxed today to pay for other people's benefits

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today, with no guarantee that the program would pay comparable benefits to them when they reached age 65.

Many government officials understood these matters clearly. Even HEW officials, when speaking to congressmen, sometimes dropped the "contributions" language and stated openly that the government's participation through Medicare "would be on a compulsory tax basis as social security is basically" (U.S. House Hearings 1963–64: 61). In executive hearings in 1965 not open to the public, Rep. John W. Byrnes (R., Wisc.) asked HEW's Robert Myers whether "fundamentally what we are doing here is *not* prepaying, but . . . having the people who are currently working finance the benefits of those currently over 65" (U.S. House Hearings 1965: 20). Myers replied, "I think it can be viewed that way, just as the old-age and survivors insurance trust fund can" (U.S. House Hearings 1965: 20, emphasis added). He added,

> You can also view that it is prepayment in advance on a collective group basis, so that the younger contributors are making their contributions with the expectation that they will receive the benefits in the future—*and not necessarily with the thought that their money is being put aside and earmarked for them,* but rather that later there will be current income to the system for their benefits [U.S. House Hearings 1965: 20, emphasis added].

Despite this moment of candor, three months later Celebrezze returned to his standard theme, testifying before the Senate Finance Committee that the Medicare payroll taxes were "earmarked" taxes and that by "this method, people can contribute during their productive years toward the hospital insurance that they will need in later years" (U.S. Senate Hearings 1965: 93).

Highlighting the transaction-cost-increasing aspects of this insurance imagery, Rep. Curtis (R., Mo.) noted that "private insurance has a very definite concept in the public's mind along with the terms 'premium,' 'prepayments' and 'actuarial soundness' and so forth. . . . Whether trading in on the fine reputation that insurance has in our society is intential [sic] or not, that is actually what is happening and there is a great public misunderstanding because of these terms" (U.S. House Hearings 1965: 35). Even SSA official Robert Myers acknowledged that "the use of the term *paid-up insurance* by the proponents tends to be misleading and creates false impressions that individual equity is present" (Myers 1970: 31).

Underlying government officials' support for the insurance approach and the myth of the separate trust fund was their desire to remove the associated taxing and spending from the official budget. Such off-budget strategies exemplify a recurrent form of political transaction-cost augmentation in the United States (Twight 1983).

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Testifying before the House Ways and Means Committee, HEW Secretary Celebrezze stated that "what we are attempting to do . . . is that we are trying to get away from making the assistance program our first line of defense—to get away from heavy Government expenditures out of general funds" (U.S. House Hearings 1963–64: 67). They succeeded, at least initially. As Marmor (1970, 1973: 22) noted, the Social Security programs were "financed out of separate trust funds that were not categorized as executive expenditures; the billions of dollars spent by the Social Security Administration were until 1967 not included in the annual budget the president presented to Congress."

Manipulation of Political Agreement and Enforcement Costs. In addition to manipulating political information costs in the ways described above, governmental supporters of national health insurance used a variety of other transaction-cost-increasing strategies to increase the costs of taking political action to resist the Medicare proposal. Even in 1965, proponents of compulsory health insurance feared that it could not be passed as a stand-alone measure. Accordingly, they packaged it with the "Social Security Amendments of 1965." Most politically irresistible among the measures contained in the amendments was an across-the-board 7 percent increase in cash benefits to Social Security recipients, a benefit increase made retroactive to January 1, 1965. The Social Security amendment package also contained politically appealing benefits such as grants for maternal and child health services, liberalization of disability coverage, and the like. Without doubt, these linkages increased the political transaction costs facing the public and facing members of Congress of resisting the compulsory medical insurance proposal.

The tying was not happenstance. In 1964 hearings had been held by both the House and Senate on Social Security amendments, including compulsory medical insurance as well as an increase in Social Security benefits. The House and Senate passed different versions of the bill increasing benefits, with the medical insurance provisions omitted from the House bill but included as an amendment to the Senate bill. When the conference committee appointed to reconcile the two bills ended in deadlock over the Medicare issue, conferees decided to forgo the Social Security benefit increase passed by both the House and the Senate in a deliberate effort to give Medicare another chance in the following year. As Rep. Byrnes (R., Wisc.) put it, "The amendments to the old-age survivors disability insurance sections of this bill could have been passed last fall if the word had not come down, and the insistence made that 'Oh, no, you have to tie all of these together because

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of the fear that the medical part of this program could not stand on its own merits' " (*U.S. Cong. Rec.-House* 7 April 1965: 7219). The administration's insistence on this linkage was central to its transaction-cost-increasing strategy.

The incrementalism that had characterized the previous 30 years of Medicare's evolution also was written into the bill's financing provisions. Payroll-tax increases extending to 1987 were specified in the bill, thereby lowering the apparent present cost to workers of the health insurance provisions. The planned pay-as-you-go financing, disguised by the bogus Medicare "trust fund," further concealed the full cost of the proposed program.[15] But chief among the incremental financing strategies was the intention, partly written into the bill, to gradually increase the wage base to which payroll taxes would apply and thereby increase payroll tax revenues to finance Medicare while avoiding politically difficult increases in payroll tax rates. Even congressmen sometimes had to dig to get the truth from administration witnesses on this topic. HEW's Robert Myers testified in 1964 that "the financing provided in the bill . . . will be sufficient to finance the proposal for all time to come," avowing that "the income in the early years is estimated to be more than sufficient so as to make up for the fact that later on the benefits will rise as there become relatively more and more beneficiaries" (U.S. House Hearings 1963–64: 58). He later admitted under questioning his underlying assumption that the "earnings base" would have to rise (via legislation) in the future to make his cost estimates valid, implying that without such increases in the earnings base for Medicare his cost estimates would greatly understate the true costs (U.S. House Hearings 1963–64: 141–46). Accordingly, planned increases in the wage base were written into the 1965 bill. Noting that the "rate of tax and the wage base is [sic], however, escalated in subsequent years," the minority report on the 1965 House bill concluded that "this 'gimmick' merely postpones the full impact of the cost" and causes Medicare's "real burden" to be "shifted to the future" (U.S. House Rept. 213, 1965: 249). Although Rep. Joel T. Broyhill (R., Va.) in his separate statement protested the fact that "the first population group that will bear the full brunt of the tax burden is the group of citizens to be born 6 years from now," concealment and shifting of the costs were keys to the bill's political viability (U.S. House Rept. 213, 1965: 261).

[15]For a discussion of pay-as-you-go financing and the "chain-letter economics of medicare," see Goodman and Musgrave (1992: 385–460).

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Another deliberate change in political transaction costs that increased the costs of resisting the Medicare proposal involved the very structure of the House Ways and Means Committee. After the 1964 elections, the House of Representatives took the "unusual" step of altering the composition of the committee with jurisdiction over the Medicare bill (Cohen and Ball 1965: 5). The result was that thenceforth there would be two Democrats on the committee for every one Republican, making it more difficult for opponents to block favorable committee action on the bill.[16]

Mills's Three-Layer Cake: Intra-Government Manipulation of Transaction Costs. Until November 1964 Wilbur Mills as chairman of the House Ways and Means Committee had been one of the primary obstacles to passage of compulsory national health insurance. After the political realignments brought about by the 1964 elections, however, he concluded that some form of Medicare inevitably would be passed. As a southern Democrat, he believed there was much to fear from allowing politics to run its course on this issue without his guiding hand. Perceiving Medicare's open-ended commitment to pay for services as a grave threat to the entire Social Security program, he wanted to control the form that Medicare would take.

Accordingly, he devised additional transaction-cost-increasing strategies to that end. Some of these strategies were aimed at the public; others were aimed at his fellow congressmen. First, he insisted that there not be any open public hearings on Medicare in 1965: the 1965 Ways and Means Committee hearings were held in executive session. Some individual witnesses were invited, but they were only allowed to discuss the technical aspects of the Medicare bill, not the philosophy behind it. Only the initial part of the hearing was published—even that duly expurgated, with many discussions omitted as "off the record." Much of the hearing was totally closed.

In the executive sessions, Mills asked witnesses to make recommendations regarding "specific technical aspects" of the bills then before the House of Representatives. Chief among those bills was H.R. 1, the King-Anderson measure discussed above. But there were other measures as well. Rep. Byrnes (R., Wisc.), the senior

[16]This change meant that the House Ways and Means Committee would consist of 17 Democrats and 8 Republicans, in contrast to its previous composition of 15 Democrats and 10 Republicans. In addition, to help the party leadership advance its agenda, the House Rules Committee had been enlarged on a temporary basis in January 1961 and on a permanent basis in 1963 (Feingold 1966: 126, 140; Marmor 1970, 1973: 60).

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Republican on the House Ways and Means Committee, had introduced a bill (dubbed "Better-care") providing for a voluntary insurance program that would cover both hospital and other medical expenses, financed partly by the government and partly by premiums to be paid by those who elected coverage. There was also an AMA-sponsored "Elder-care" bill introduced by Rep. Curtis (R., Mo.) and Rep. Albert Herlong (D., Fla.), the thrust of which was to strengthen the existing Kerr-Mills program that paid medical expenses for the aged poor.

Stripped of most ideological discussion by Mills's edict, the hearings were a pretty dull affair. Nonetheless, the aspirations of Blue Cross executives and Mills's vision of Blue Cross's intermediary role became evident as never before.[17] Walter J. McNerney, president of the Blue Cross Association, recommended that, under Medicare, "it would be desirable . . . to have one carrier, perhaps with the Secretary [of HEW] authorized after consulting with the hospitals to contract with this carrier." He added,

> Whether it is on the basis of a low responsible bid or whether it is on the basis of the prejudice expressed by the providers of care, I have no explicit preference. However, we are equipped and would be able to move into action within days in our traditional capacity of, after initial eligibility has been established, doing the rest of the job [U.S. House Hearings 1965: 160].

Rep. Albert Ullman (D., Ore.) later remarked that "it has been generally prognosticated here that the probable carrier would be Blue Cross, and probably on a nationwide basis" (U.S. House Hearings 1965: 490). This much was unvarnished interest-group politics.

But Mills had more in mind than benefiting Blue Cross. It became clear that he envisioned Blue Cross as an intermediary capable of mitigating resistance to the Medicare program. Mills asked McNerney, "Could we proceed with the statutory requirement administered by you without the charge being made in the confrontation between hospital and Government that Government was trying to some extent to intrude in medicine and hospitalization, do you think?" (U.S. House Hearings 1965: 177). Hospital representatives sounded the same theme. Kenneth Williamson, Associate Director of the American Hospital Association (AHA) stated, "We would like Blue Cross in to handle the payments to hospitals, to administer the cost formula negotiated with the Secretary for reimbursement purposes. . . . We would like them to provide all relationships between the Federal Government."

[17]Wasley (1992: 47–58) provides insightful discussion of the history and impact of Blue Cross and Blue Shield.

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Williamson added that the AHA preferred to have Blue Cross provide all hospital "utilization review," because having the federal government do it would cast the government in the role of "appearing to question or interfere in medical practice" in a way that would "cause considerable furor" (U.S. House Hearings 1965: 287).

In short, in Mills's vision Blue Cross would deflect opposition to the expanded involvement of the federal government in crucial medical decisions affecting the survival of older patients—just as employers had deflected public opposition to government by becoming tax collectors under the Social Security and federal income tax withholding laws (Twight 1993, 1995) and just as local draft boards had deflected opposition to military conscription in World War I (Higgs 1987: 133–34). Blue Cross would serve as a lightning rod, increasing the transaction costs to the public of resisting involvement of the federal government in the practice of medicine.

Despite the constraints Mills set on the 1965 House hearings, committee members' fear of the incremental expansion of Medicare was palpable. Rep. Curtis (R., Mo.) said he "would be less worried if this really were the limit of what you are doing, and not . . . just a foot in the door on which to further get the government in" (U.S. House Hearings 1965: 58). Similarly, Rep. Harold R. Collier (R., Ill.) asked HEW's Wilbur Cohen, "Don't you feel that . . . within 4 to 6 years this program . . . would be expanded to full and complete medical coverage of all types?" (U.S. House Hearings 1965: 123). Cohen replied,

> I think that is not necessarily so. . . .[I]t seems to me that it could be avoided by so designing a system of what some people have either called a *three-legged stool, or a three-layer cake*, of basic protection through social security, through Kerr-Mills, and private insurance [U.S. House Hearings 1965: 123–24, emphasis added].

It was the first mention of an idea that was to shape subsequent government involvement in U.S. health care.

To the surprise of many, what emerged from the House Ways and Means Committee with a recommendation for passage was just such a "three-layer cake." In executive sessions closed to the public, Mills proposed and got his committee to approve legislation along the lines suggested by HEW's Cohen. The first layer was compulsory federal hospital insurance under the Social Security program, financed by additional payroll taxes. The second layer was "voluntary" medical insurance ("supplemental medical insurance") that would pay physicians' fees, with premiums half financed by subscriber and—despite the claimed voluntary nature of the insurance—half financed out of general revenues of the federal government. The third layer was an

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expansion of the Kerr-Mills program of medical assistance for the elderly poor, financed partly by the federal government and partly by the state governments. The redrafted Medicare provisions were included in a Social Security Amendments bill that was rechristened as H.R. 6675.

Why the three-layer cake? Mills himself stated that inclusion of supplemental medical insurance would "'build a fence around the Medicare program'" (Marmor, 1970, 1973: 69); Derthick (1979: 332) described it as "a buffer against further changes in social insurance."[18] Viewed in terms of transaction-cost-augmentation theory, Mills successfully increased the transaction costs to other legislators and to the public of opposing the Medicare bill. It became a tied "package deal" within the overall package deal of the Social Security Amendments of 1965. There was something in it for everyone. Indeed, many of the standard arguments against compulsory government health insurance were countered by inclusion of programs that were ostensibly "voluntary," that provided for routine doctors' bills, and that increased government medical programs for the needy.

Moreover, following the general practice of the Ways and Means Committee, Mills insisted that the committee's bill be considered by the House under a "closed rule" that prevented floor amendments. In floor discussion, representatives complained bitterly about these transaction-cost-increasing strategies. Rep. Curtis (R., Mo.) said he had "urged that there should be open hearings and people with knowledge in our society on this subject should be given the opportunity to come before us" (*U.S. Cong. Rec.-House* 4 April 1965: 7229). Curtis recounted the secretive nature of the committee's deliberation:

> There was H.R. 1, which was a new bill, 139 pages long, and the confidential print which the chairman had made up for the committee of some 250 pages, which many of us had not seen until it came in. Under the orders of the chairman, this print was not to be taken out of the committee room [*U.S. Cong. Rec.-House* 7 April 1965: 7231].

Rep. Durward G. Hall (R., Mo.), a physician, judged the fact that "at no time during the week this bill was drafted, were the Nation's doctors asked to contribute to the deliberations" to be "the most brazen act of omission ever committed on a piece of major legislation" (*U.S. Cong. Rec.-House* 7 April 1965: 7394). Rep. James D. Martin (R., Ala.) stated that he "would have preferred that hearings be held on the specific legislative proposals now before us so that [he] could

[18]For a contemporaneous account of the emergence of Mills's three-part Medicare program, see Meyers (1965).

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study that record" (*U.S. Cong. Rec.-House* 7 April 1965: 7416). Protesting that "for this House to be denied the opportunity to amend such a comprehensive bill—denied even the opportunity to strike one of its titles—is beyond belief," Rep. Delbert Latta (R., Ohio) asked "why the administration and the medicare backers were afraid to let this so-called medicare part of this bill come to the floor of the house by itself—or at least under a rule permitting amendments—and be voted up or down on its own merits" (*U.S. Cong. Rec.-House* 8 April 1965: 7420).

Sentiments ran so high that, despite the Democrats' two-thirds majority, on a motion to recommit the bill 191 representatives voted in favor of the motion, 236 against—perhaps a stronger indication of House sentiment than the vote immediately thereafter on passage of the bill (313 yeas; 115 nays) (*U.S. Cong. Rec.-House* 8 April 1965: 7443–44). Nonetheless, both votes signaled the success of Mills's transaction-cost-increasing strategies.

The bill (H.R. 6675) then went to the Senate, where floor action was not constrained by a closed rule. After voting 64–26 (10 senators not voting) against striking the Medicare provisions from the bill, the Senate voted 68–21 (11 senators not voting) for the bill's passage (*U.S. Cong. Rec.-Senate* 9 July 1965: 16100, 16157). Following conference committee deliberation, Congress adopted the conference committee report: the House of Representatives on July 27 by a vote of 307–116; the Senate on July 29 by a vote of 70–24. President Lyndon B. Johnson signed the Social Security Amendments of 1965 into law on July 30, 1965.[19] As Wasley (1992: 65) put it, "In an instant, with the passage of Medicare and Medicaid, the government had become the largest single purchaser of health care."

Determinants of Transaction-Cost Augmentation in 1965

Political transaction-cost augmentation was indispensable to passage of the 1965 Medicare legislation. We have seen the misrepresentation, cost concealment, tying, incrementalism, and procedural stratagems by which government officials raised the transaction costs to voters of resisting passage of Medicare. Were contemporaneous changes in the posited determinants of political transaction-cost augmentation consistent with the observed outcome?

[19]See Cohen and Ball (1965) for further discussion of congressional action on the Social Security Amendments of 1965 as well as H.R. 6675's substantive provisions. For a useful summary of the differences between the 1965 King-Anderson bill (H.R. 1 and S. 1), the Mills bill (H.R. 6675) as passed by the House, H.R. 6675 as recommended by the Senate Finance Committee, H.R. 6675 as passed by the Senate, and H.R. 6675 as enacted into law, see Feingold (1966: 148–55).

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The answer is yes. Some of the determinants, while supportive of government officials' decisions to employ transaction-cost augmentation, did not change in 1965. Several of the key determinants, however, showed changes that gave unique impetus to pro-Medicare political transaction-cost augmentation in 1965.

In 1965 the executive support, party support, ideology, and media publicity variables more strongly favored transaction-cost augmentation on the Medicare issue than in any previous year. Both President Roosevelt and President Truman had favored compulsory national health insurance, but for a variety of reasons—Social Security, World War II, the Korean War—each had had to put Medicare legislation on the back burner. President Kennedy was constrained by his narrow electoral margin. In contrast, after making Medicare a major campaign issue, President Lyndon Johnson won a landslide victory and proceeded to support Medicare actively as one of the pillars of his "Great Society" agenda. Active presidential support for Medicare and the transaction-cost-increasing measures needed to pass it thus encouraged other government officials to employ transaction-cost-augmenting measures on this issue as never before.

Party support for such measures likewise reached unprecedented levels in 1965. With the 1964 elections, Democrats held not only the White House but also two-thirds of the seats in the House and in the Senate, making the 89th Congress "the most heavily Democratic Congress since Franklin Roosevelt's 1936 sweep" (Feingold 1966: 137). The ideology variable also suggested the observed outcome. In 1964 not only were more Democrats elected, but anti-Medicare Democrats were replaced by pro-Medicare Democrats. With more government officials both in Congress and in the administration ideologically favorable to the expanded role for the federal government represented by Medicare, the model would predict that these individuals would be more likely to favor transaction-cost-augmenting measures to that end.

The fact that no public hearings were held in the House of Representatives in 1965 meant that the media were less able to inform the public regarding transaction-cost-increasing features of the legislation. Rep. James F. Battin (R., Mont.) noted that if open hearings had been held "the working press of the country could then have advised the people of all 50 States on what the proposals were, the arguments for and against, and then we as representatives of the people could have had an expression from our constituents on their thinking" (*U.S. Cong. Rec.-House* 8 April 1965: 7399). The lack of publicity given to transaction-cost-increasing features of the legislation also favored government officials' support for such measures.

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Variables that continued to influence government officials to support Medicare's transaction-cost-increasing features in 1965 as in previous years included the measure's appealing justification, complexity, perceived importance to constituents, and conduciveness to third-party payoffs and political job security. Medicare was continually represented as, in HEW Secretary Celebrezze's words, a measure designed for the "prevention of dependency and destitution" (U.S. House Hearings 1965: 3). Questioning the validity of that rationale, Senator Long (D., La.) stated that he believed that he "could defeat any Senator in any area of the Nation by showing that old Grandpa Jones had been thrown out for the vultures to take care of after he had exhausted his resources and the benefits available to him under the bill" (*U.S. Cong. Rec.-Senate* 7 July 1965: 15823).

Medicare's complexity also was conducive to transaction-cost augmentation, making it easier for experts to dissemble and for nonexperts to err. Senator Philip A. Hart (D., Mich.) called the 296-page 1965 bill "one of the broadest and most complex collections of social security amendments ever brought before this body" (*U.S. Cong. Rec.-Senate* 7 July 1965: 15812). From a congressman's perspective, the apparent importance of Medicare to major groups of constituents—such as the elderly and adult children with aged parents—also favored transaction-cost augmentation in support of such legislation. The Medicare program also promised third-party payoffs, given the diverse and powerful special-interest groups involved. The passage of time in the years leading up to 1965 served chiefly to entrench beneficiary interest groups. Finally, Medicare heralded enhancement of political job security by creating new and broad-based dependence on government.

For the first time, in 1965 all of the determinants of transaction-cost augmentation pushed in the same direction on the Medicare issue. Concomitantly, after decades of rejecting compulsory health insurance, Congress relied heavily on transaction-cost augmentation in passing Medicare legislation.

Conclusion

Congress members knew in 1965 that in passing Medicare they were legislating for all time to come. Political transaction costs had been molded to accomplish precisely that end. Senator Mundt (R., S.D.) regarded it as an "irreversible step" in that Medicare "would be exceedingly difficult to discontinue without breaking faith with those who have to pay the tax" (U.S. House Hearings 1963–64: 264). Senators and administration officials alike understood that they were

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"legislating in perpetuity" and would face strong pressures to expand the program (U.S. Senate Hearings 1965: 134). They also knew that Medicare would create a vast new public dependence on the federal government for financial security in old age, continuing the pattern set by Social Security in 1935. Senator Mundt (R., S.D.) described it as "another step toward destroying the independence and self-reliance in America which is the last best hope of individual freedom for all mankind" (*U.S. Cong. Rec.-Senate* 9 July 1965: 16122). Moreover, legislators knew that Medicare would take money from the poor and middle classes to subsidize the rich. Senator Gordon Allott (R., Colo.) described it to the Senate as a "program of 'Robin Hood in reverse' " that showed "complete disregard for need in disbursement" and represented a "giant step" toward making "every citizen as dependent as possible on his Government for his every need" (*U.S. Cong. Rec.-Senate* 8 July 1965: 15935).

But they also knew that Medicare would serve their political interests. As majority leader Rep. Carl B. Albert (D., Okla.) told his colleagues on the House floor, H.R. 6675 "is a bill which in my opinion will serve well those of us who support it, politically and otherwise, through the years" (*U.S. Cong. Rec.-House* 8 April 1965: 7435). Or, as Rep. Phillip Burton (D., Calif.) more crassly expressed it, "This bill is going to put into the pockets of my fellow Californians some $213 million its first year . . . All in all our fair State and its people in the first year will be favored to the tune of some $550 million, a not modest sum" (*U.S. Cong. Rec.-House* 8 April 1965: 7429). Without doubt, the Social Security Amendments of 1965 were "so drafted that quite a bit of honey [had] been placed under the beehive in order to attract the bees" (*U.S. Cong. Rec.-Senate* 9 July 1965: 16071).

We have seen that political transaction-cost augmentation enabled government officials to embed Medicare in America's institutional structure at precisely the time when all the theoretical determinants of such behavior supported its pro-Medicare use for the first time in U.S. history. Indeed, the strategies most influential in passing and entrenching Medicare had as their goal and effect the manipulation of political transaction costs. By tying Medicare with a 7 percent increase in Social Security benefits, proceeding incrementally, narrowing the bill's coverage, misrepresenting its content, concealing its costs, and using countless other transaction-cost-increasing strategies described in this paper, government supporters of Medicare were able to achieve their objectives. These same tools, so instrumental in passing Medicare, today continue to serve those who seek further increases in federal control over U.S. health care. Their recent use in enacting previously reviled features of President Clinton's 1993

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Health Security Act as part of the Health Insurance Portability and Accountability Act of 1996 warns anew of their potent ongoing role in the growing power of the federal government to control personal health care decisions (Twight 1998).

On the day the House of Representatives passed the Social Security Amendments of 1965, Rep. Hall (R., Mo.) spoke at length about the attempt being made under Medicare "to conceal the grant of power which would be extended to the Secretary of Health, Education, and Welfare to interfere with administration and medical practice in participating hospitals." Explaining why the federal government could not tell engineers and bookkeepers how to do their jobs, he remarked that "Men bred in freedom learn to like the taste of it" (*U.S. Cong. Rec.-House* 8 April 1965: 7392). From the perspective of many government officials who had pushed for decades to institutionalize Medicare, that was the point. In the future, fewer would learn to like the taste of it. So it has been. Americans' willingness in 1993 to seriously discuss a virtual government takeover of medical practice in the United States via President Clinton's 1,342-page Health Security Act attests to the long-run power of such changed institutions to reshape people's ideologies and thus the degree of government authority to which they acquiesce.

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The Market Value of Family Values

Ralph Chami and Connel Fullenkamp

Recently, family issues have received much attention from politicians and social commentators. The debate has centered, for the most part, on the decline of "family values" and the commensurate decline of "work ethic" among partcipants in the labor market. Although economists have no way of measuring values or work ethic directly, they may nonetheless be able to find evidence of changes in values and work ethic to the extent that these changes affect different markets. An extensive literature on the economics of the family has emerged over the past 20 years that documents and analyzes economic interactions between family members, such as bequests and gifts, or inter vivos transfers. When it comes to showing the impact of these family interactions on labor and financial markets, however, economists for the most part have remained on the sidelines. In this paper, we bring economics to the heart of the discussion of family values by using the insights gleaned from existing and recent work on the family to forge and highlight the integral link between the family and the market.

Family Income Transfers and Family Values

Among economists it is well known that familial economic support—whether between parents and children or between spouses—is quite common and represents a significant portion of U.S. wealth accumulation. Moreover, there is now an extensive literature on these transfers that documents their size. Kotlikoff and Summers (1981) estimate bequests to account for four-fifths of U.S. wealth accumulation, Cox (1987) gives an estimate of 63 billion dollars in inter vivos transfers and 40 billion dollars in bequests (in 1979 dollars), and more recently

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Wilhelm (1996), using estate tax data from 1988, puts the size of bequests at 130 billion dollars. While we usually think of transfers in monetary terms, these figures do include the value of transfers of goods and services. What they do not include, however, is the value of any gifts given by parents to children under the age of 18. These transfers, though difficult to disentangle from "regular" family consumption, are regarded by family members as being different from usual consumption expenditures and should be included in inter vivos transfers. If included, the total value of inter vivos transfers would be far greater.

Researchers differ as to the motivation behind such transfers. One strand advocates altruism (e.g., Becker 1974), which is the idea that parents care about the happiness of their children and make transfers because they believe the transfers will make their children happy. Another strand argues that benefactors are exchange motivated (e.g., Bernheim et al. 1985), which is the idea that parents are selfish and dangle possible gifts and bequests in front of their children to entice them to give parents the attention they want. Yet a third contends that transfers are accidental (e.g., Abel 1985).

A variation on the exchange motivation for transfers, which comes from other social sciences, links family income transfers to family values quite transparently. This research suggests that gifts and monetary transfers are an essential mechanism through which parental or spousal values and aspirations are conveyed to other family members. Developmental psychologists and sociologists have long recognized the inherent relationship between gift giving and the values of the benefactor. For instance, Schwartz (1967: 2) argues that "the gift is an imposition of identity," while Sussman (1965: 91) points out that parental giving may influence, among other things, the child's "motivation to achieve." Famed examples of parents realizing this link include Commodore Vanderbilt, Andrew Carnegie, and more recently, Warren Buffet. In the case of Commodore Vanderbilt, his more hard working child was favored in the will and put in control of the trust fund set up for the less industrious brother (Clark 1966). Warren Buffet recently indicated that his concern for the potential negative impact of his sizable estate on his children's work effort has convinced him to leave most of his fortune to the Buffet Foundation (Greenwald 1995).

Economists have incorporated into their research agenda the idea that income transfers and value transfers are linked. Interestingly, they have found that the timing of such transfers is critical in determining their effect on the beneficiaries' values and behavior. Assuming that the parent can observe the child's actions, Hirshleifer (1977)

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points out that if the parent were to decide on the transfer before the child decides on his action, then the parent will face what Becker (1974) termed the "Rotten-kid" problem. That is, the child, after receiving the transfer from the parent, has little incentive to abide by the parent's wishes. The result is bad behavior by the child—to the dismay of his parent.

If instead the parent chose to make transfers only after the child has taken his action, the parent may face what Buchanan (1975) termed the "Samaritan's Dilemma"—that is, the child, in anticipation of the parent's transfers, would overconsume so as to engender a higher future transfer from his parent.[1] This problem is exacerbated when the parent is dealing with an adult child, where the parent may not necessarily know the action taken by the child. For example, the parent may not be able to ascertain whether unemployment or low wages are due to the child's low effort or to bad market conditions. In this case, if the parent were to opt for having the last word, then the child stands to gain from the benefit of the doubt, which can only provide a disincentive for the child to raise his work effort. On the other hand, if the parent were to precommit to a certain transfer rule, then the child's effort is certainly higher in this case, since the child does not expect to receive any help should he expend lower effort and raise the probability of low output.[2] This could partly explain the surge in the past five years in the use of "trust funds" by parents, who may resort to such incentive trusts as a way to precommit to transfer rules that reward children for actions that accord with the parent's values (Pederzane 1995).

The economics literature, for the most part, has concerned itself with the dynamics of the nonmarket interaction between the parent and the child or between spouses, and assumed the market activity of the transfer recipients to be exogenous. But a small literature that explores the interaction between family income transfers and market activity of the recipients does exist. Arnott and Stiglitz (1991), in the case of insurance markets with moral hazard, but in the absence of altruism, show that nonmarket transfers—by lowering the effort that individuals take to avoid accidents and raising the probability of accidents—lead to the crowding-out of market insurance. However, altruistic transfers may actually complement market insurance, especially in the case where partners care enough about each other's welfare

[1]For a discussion of the benefits of the last word in the case of perfect foresight, see Hirshleifer (1977, 1985) and Becker (1991) when uncertainty is present.

[2]See Chami (1996) for a discussion of the benefits of precommitment.

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(Chami and Fischer 1996).[3] In the context of labor markets, Holtz-Eakin et al. (1993) show that inheritances appear to lower the labor supply and labor market participation of the recipients. But virtually no work has been done on how wages, employment levels, and labor contracts reflect the presence of such nonmarket transfers. We now turn to our analysis of this interaction.

Parental Transfers and the Labor Market

Our first task is to build a vehicle for exploring the interaction between altruistic transfers among family members and the market. To make our ideas concrete, we focus on the labor market, though the results can be generalized to other markets.[4] Similarly, although we couch our discussion throughout the rest of the paper in terms of the parent-child relation, our analysis can accommodate more general settings that include spouses and partners who are linked, though not entirely, by altruism. By allowing for family members, such as adult children or partners, to engage in market activities, members of the family are empowered with certain independence in their decision making. This contrasts with the existing literature, which has typically viewed the parent-child framework from the perspective of the parent, and subsumed the decisions of the child or other family members within that of the parent.[5] By focusing solely on the welfare of the benefactor, those models imply that any conflict resolution in favor of the parent is pareto efficient.[6] And under the assumption that a parent can fully observe the activities of her adult child, the parent can dictate the action to the child that maximizes the parent's utility.

By introducing an outside market, such as a labor market, into our framework, we become obliged to consider children as economic agents who make decisions independently of their parents. In other words, parents cannot completely control the behavior of their children. Furthermore, we relax the assumption usually made in the literature that a parent is able to observe the activities and opportunities of her children. Parents gradually lose the ability to observe the activities of their children as the children approach adolescence and

[3]See Stark (1989) for a similar argument in the context of the family and in the absence of an outside market.

[4]In particular, all of the ideas discussed in this article apply in a straightforward way to insurance markets, or any other market in which some agents act in ways to insure others against some risk.

[5]This criticism is voiced in Lazear and Michael (1988), and more recently in Haveman and Wolfe (1995).

[6]In an empirical study, Udry (1996) shows that Pareto efficiency may not obtain when other members of the same family are modeled independently.

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spend more time outside the home. The inability of the parent to discern the child's activities is complicated by the uncertainty inherent in the market, where luck helps determine the child's wages and employment opportunities. In this case, parents may want to rely on the child's output as a sign of the effort level expended. But since market luck is present, the child has the advantage of private information regarding his true effort, which he may choose not to reveal to his parent so as to enjoy the benefit of the doubt.

We incorporate the above ideas into a model of a game whose rules and timing are as follows. The basic game has four players: a parent, a child, the firm, and nature. The parent is altruistic in the sense that in addition to caring about her own consumption, she also receives utility from the child's utility—the happier the child, the happier the parent. The child receives utility from consumption and disutility from expending effort in the workplace. To make the asymmetry in altruism clear, we assume that the child does not care about the parent's happiness at all, though all that is necessary to support our conclusions is a situation in which the parent cares about the child's utility more than the child cares about the parent's utility. The firm is a profit-maximizing business producing for a competitive market, and nature is the source of market luck.

The game proceeds in this order. First, the parent makes a transfer of resources to the child. Next, the child secures a labor contract from the firm and then decides on the level of effort he will expend on the job. Finally, this effort is combined with luck to determine the market outcome. The actions we are interested in analyzing include the choice of labor effort on the part of the child and the choice of transfers on the part of the parent. We are also interested in showing how the labor market reacts to these choices, and what consequences this reaction has for parent and child. Ultimately, we intend to piece together the relation between the level of transfers made by the parent, the level of effort chosen by the child, and market outcomes.

An essential step toward understanding the effects of parental transfers on the labor market is to realize that the motivation behind such transfers will be reflected in the types of transfers made. When the parent behaves altruistically— that is, cares directly about the welfare of her child—her transfers, at the margin, will be compensatory in nature. In other words, such transfers are subsidies that attempt to shield the child from, or compensate the child for, possible bad luck in the market.[7] As long as the child does not share the parent's level of altruism, such transfers can only lower the effort of the child in

[7]See Cox (1987) and Menchik (1988) for a discussion of this result.

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the labor market. While the parent intends the transfer to make up for possible bad luck, the child will use the transfer to substitute for effort, which he does not like to expend. For example, absenteeism and incidences of shirking on the job may rise in the labor market, and reckless behavior that increases the possibility of injury also rises in the insurance market. Holtz-Eakin et al. (1993) provide empirical evidence that recipients of inheritances do lower their labor supply and labor force participation. This problem is exacerbated when parents cannot directly observe the child's actions, since the parent cannot accurately infer the extent to which the child's wage outcome is due to luck rather than effort. The child will take advantage of this information asymmetry by further lowering his effort level, receiving the benefit of the parent's doubt in a literal, monetary sense.

The above scenario analyzes the case in which the parent only cares about the welfare of the child without trying to directly impose her will and expectations on her child. But as alluded to earlier, work by Sussman (1965) and Schwartz (1967), among others, argues that parents not only take an active interest in their children's actions, but may also try to influence their children's decisions. Sussman (1965: 91) points out that parental authority extends to "occupational choice, mobility of children and . . . mate selection." Here, the parent is not only altruistic, but also cares directly about the actions taken by the child. Becker (1991: 9) calls this the "merit good" case, where the term merit good refers to the action or behavior the parent cares about. When a merit good is present in the parent's utility function, parental transfers differ in type and in quantity from the case in which the parent is only altruistic. While transfers would continue to provide some compensation for bad luck, transfers now also take the form of incentives that are intended to induce higher effort from the child. For example, the parent can link transfers to the child's effort, or some measure of effort such as income or occupation in the case where effort is unobservable. This leads to parental transfer schemes under which, if the child's income is low, then transfers are lower than in the case in which the child's output is high. Indeed, Vanderbilt, in his will, instructed that his younger and less industrious son be provided with a trust fund that only rewarded his son for "exemplary" behavior.

The merit good, in our analysis of the labor market, is the effort put forth by the child. Parents care directly about this merit good because they know—usually better than the child—that effort is associated with success in life and greater happiness in the long run. Work effort is so important to success and happiness that society has developed a moral value associated with it: work ethic. Parents want

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their children to develop a strong work ethic. Children, who do not like to expend effort because they do not receive immediate rewards for doing so, will not develop a work ethic without some kind of external provocation. Parents therefore provide incentives to build up the work ethic of their children, and they do this in great part through the use of carefully designed transfers. Thus, parental expectations and values, reflected in the type of transfers made, play a pivotal role in providing incentives for the effort decisions of their children.

The question now is, why should parental transfers affect market profitability? First, such forms of transfers, which include bequests, inter vivos transfers, spousal support, and income pooling, are quite large and commonplace. Second, whereas individual parents and partners correctly perceive themselves as price takers in the market, it is the *collective* impact of the behavior of the recipients of such transfers, through their action in the marketplace, that affects market prices. Thus, although competitive firms may not observe the amount of nonmarket transfers made to the beneficiaries, they will feel the impact of such transfers through the effort level expended by beneficiaries, which in turn will affect the profit margins of the firms. For example, if purely altruistic transfers prevail, then effort expended by workers will be lower, which lowers productivity, raises costs associated with absenteeism, and lowers expected profits for the firms. In the case of labor markets, firms will react to such behavior by exposing the workers to higher risk in order to realign incentives and engender higher effort. This is done by increasing wage dispersion and decreasing job security. The market increases wage dispersion by lowering the market wage for less skilled work and paying a higher premium for skilled labor, by lowering base salaries and relying more on bonuses, and by eliminating fringe benefits. The market decreases job security by increasing layoffs and by replacing full-time employees with contract workers or temps. All of these actions serve to shift risk from risk neutral firms to risk averse individuals, which reduces the efficiency of the market.

The above discussion highlights the role families play in affecting equilibrium market outcomes and how families, in turn, are affected by the market's reaction. Parental values and expectations are reflected in the type and level of transfers made. These differing types of transfers will have disparate effects on the effort decision of the recipients. Thus, the family imposes negative or positive externalities on the market depending on parents' expectations regarding their children's behavior. These externalities cannot be priced out completely by the market, since the source of risk is not entirely exogenous but partly determined by the market participant's effort decision. The market responds to the externality imposed on it by altering

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equilibrium prices and quantities of labor, which changes family welfare. It is in this sense that the family values play a central role in forming market outcomes. Ideally, families would have a constructive role in reinforcing market discipline, which will increase efficiency and raise welfare for all market participants.

Public Transfers and Family Values

Public transfers typically attempt to provide a "safety net" that raises or preserves the recipient's welfare in the face of hardship or misfortune. In this respect, government transfers function very much like transfers from altruistic parents to their children: they are compensatory in nature. Given what we have learned about altruistic family transfers, we can say that compensatory government transfers may have the unintended effect of lowering the recipient's welfare. Children, knowing that the government will make transfers to them if their incomes fall short, will choose reduced levels of effort, effectively substituting the transfers for the extra income they would have expected to earn by expending higher effort in the labor market. Reduced worker effort will lower expected profits for firms in the market, who will react by lowering employment and increasing wage dispersion. The invisible hand shifts more risk to transfer recipients in an effort to reestablish their incentive to expend high effort. The net effect is that transaction costs for market participants are higher, with risk averse agents—families, and eventually the government—having to absorb more risk. As a result, overall efficiency and welfare is lower. Since the child did not take into account the effect of his actions on the market, the fall in real income he experiences is likely to be greater than the increase in welfare made possible by the government transfer. Therefore aggregate welfare can fall.

The above scenario leaves parents out of the picture. When we include them, we can show that government transfer programs can harm family values and parents' welfare as well as children's welfare. We consider the case in which parents are altruistic but also care about a merit good. Compensatory public transfers act as substitutes for family transfers by providing their recipients with an additional avenue through which they can obtain resources for consumption. Because they substitute for parental transfers, which reflect parental expectations and wishes, public transfers provide an alternative to children who may not share their parents' aspirations.[8] In other words,

[8]A similar result, albeit in a different context, is found in Chami and Fullenkamp (1996), who study the role of private and public transfers in affecting teenager choices, including fertility, wage earnings and labor supply.

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government transfers provide children with a way to disobey their parents without suffering any consequences. Thus government transfers interfere with the ability of parents to pass their values on to their children and to control their children's behavior.[9] This lower consumption of the merit good lowers parental welfare. For example, Milton and Rose Friedman (1980) pointed out that the introduction of Social Security could be the reason behind the decline in the level of attentiveness given by children to their parents. As the above analysis would suggest, a possible explanation is that public transfers compete to a certain extent with parental transfers in affecting children's behavior. Children substitute Social Security wealth for parental bequests in their consumption calculations and maintain their welfare without having to expend as much effort visiting their parents.

The evidence from academic studies on poverty, while it does not focus on the connection between government programs and parental influence, also suggests that government programs have significant effects on the behavior of children. For example, Haveman and Wolfe (1994), in their summary of recent research, report that welfare recipiency on the part of parents greatly increases the chances of a child becoming a welfare recipient, and that the generosity of state welfare benefits influences duration of welfare recipiency. Some social commentators have used this evidence to support their views that government transfer programs have created a culture of dependency and idleness among transfer recipients. While this may be true, it has not yet been proven by rigorous research. Nonetheless, this evidence does tend to confirm that government programs create career and lifestyle paths that compete with the traditional paths preferred by parents and firms.

So long as public transfers are primarily intended to compensate recipients for bad outcomes, they will tend to interfere in the dynamics of family interaction and harm the welfare of all family members. It is reasonable to argue, therefore, that such compensatory social programs should be cut back or even eliminated.

Conclusion

The family plays a pivotal role in affecting the market through its provision of income transfers. These transfers, by affecting the choices made by market participants, can either complement the market or

[9]A report of the National Academy of Sciences Panel on Adolescent Pregnancy and Childbearing entitled *Risking the Future* (Hayes 1987) cites a decline in parental authority and responsibility as one of the main causes of the high rate of teenage pregnancy in the United States.

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impose costs on it. The market, therefore, places a significant value on family values—though not for their own sake. Family values, such as work ethic, have a tremendous impact on the bottom line, through their effects on the skill accumulation and productivity of employees. When work ethic is effectively passed from parents to children, firms will be more productive and will pass their gains to workers in the form of higher wages, lower unemployment, and lower uncertainty about wages and employment in general. But when work ethic declines or is not passed from parent to child effectively, the market reacts to lower efficiency and higher costs by passing these costs on to the family in the form of greater uncertainty about wages and job security. This is essentially the same story of market discipline that plays out with respect to any business practice: actions that raise efficiency and deliver value are rewarded, while actions that lower efficiency and reduce value are punished.

If work ethic and other family values are indeed in decline, as some observers would suggest, then economists should be able to detect the effects of this decline in data on wage dispersion, employment dynamics, and labor contracts. On the other hand, a word of caution is in order before we search for any links between market outcomes and the state of family values in our society. Public warnings about moral decay are as old as the concept of morality itself. Indeed, the practice of older generations of a society criticizing the morals of younger generations is one of our most observed if not most honored traditions. Perhaps these condemnations and warnings are simply another mechanism by which parents ensure that their values are transfered to their children. If this is truly all that the current debate over family values represents, then it is unlikely that economists would find any measurable effects when they conduct their experiments.

As this paper shows, however, the transmission of family values from parents to children has probably been harmed by the emergence of government social insurance programs. These programs, which have only existed for the past two generations, represent a new development in the cycle of family values. Our model suggests that these programs, in their current form, interfere with parental influence and prevent values from being passed effectively from one generation to the next. Their effect, moreover, has probably become more pronounced within the last 25 years as the variety and generosity of government transfers have increased. The introduction of government programs, therefore, can be interpreted as a shock to the system that upset the balance between the family and the market. This raises the likelihood that economists can find evidence of the effects of government programs on work ethic through the programs' effects on

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wage and employment data. Carrying out the empirical investigations suggested by this paper, therefore, appears to be a worthwhile endeavor.

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Compensating Behavior and the Drug Testing of High School Athletes

Robert Taylor

On June 26, 1995, the United States Supreme Court ruled in *Vernonia Sch. Dist. 47J v. Acton* that middle-school and high-school athletes can be required to submit to suspicionless drug tests as a condition of athletic participation (Greenhouse 1995). Although the decision removed a major constitutional roadblock to the adoption of such programs by public schools nationwide, the response was initially tepid: as of January 1996, six months after the ruling, only 1 percent of the country's 16,000 public high schools had implemented random drug-testing programs. For many schools, the financial barrier of drug testing ($20 to $30 per standard drug screen; $100 per steroid test) proved far harder to surmount than the constitutional barrier (Dohrmann 1996).

In the past year, however, the number of schools engaged in drug testing has continued a slow but steady rise. For instance, the high school in Kokomo, Indiana, began subjecting all students who participate in extracurricular activities to random drug testing in April 1996 (Glass 1997: 20), and the city of Oceanside, California, began a drug-testing program for its high-school athletes early in 1997 (Penner 1997). Future improvements in testing technologies that lower costs and increase reliability promise to accelerate the spread of such testing (Reuter 1988: 556).

Not surprisingly, suspicionless drug testing has come under attack from a number of quarters. Civil libertarians (e.g., Shutler 1996) and newspaper editorialists (e.g., Berkow 1995, Goodwin 1995, Bradley 1995) have assailed the Supreme Court decision and condemned random drug testing of student athletes as an unjustified invasion of

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privacy. Physicians have also criticized such testing, arguing that there is little evidence that student athletes are more prone to drug use or abuse than their nonathlete peers (Schnirring 1995: 25).[1] For example, a host of studies has been completed over the past 15 years examining drug use among college athletes (e.g., Toohey and Corder 1981, Anderson and McKeag 1985, Anderson et al. 1991) and college students in general (e.g., Johnston, O'Malley, and Bachman 1988). Table 1 is reproduced from the most recent of these studies. It compares drug use rates for the general college population with drug use rates for varsity athletes from 11 NCAA schools that did not have drug testing programs at the time of the survey. Table 1 strongly suggests that drug use among college athletes is significantly lower than use in the general college population for a whole host of drugs, including alcohol—even in the absence of drug testing.

The data presented in Table 1 suggest a disturbing, previously unnoticed problem with random drug testing of student athletes. Participation in student athletics is strictly voluntary and is likely influenced by the costs (e.g., lost leisure time) and benefits (e.g., prestige) of participation. Drug testing, by invading the privacy of

TABLE 1

DRUG USE BY VARSITY ATHLETES AT 11 NCAA SCHOOLS DURING PREVIOUS 12 MONTHS COMPARED WITH DRUG USE BY GENERAL POPULATION OF COLLEGE STUDENTS (PERCENT)

	Varsity Athletes		College Students	
Drugs	Males (n = 1,552)	Females (n = 730)	Males (n = 520)	Females (n = 700)
Alcohol	90*	87*	93	90
Amphetamines	3**	3**	7	7
Cocaine/Crack	6**	4**	19	14
Marijuana/Hash	29**	25**	41	34

NOTES: Two-sample test of proportions (large sample)—null hypothesis: equal proportions; alternative hypothesis: college student proportion higher than corresponding athlete proportion.

* Difference in proportions significant at 5 percent level.

** Difference in proportions significant at 1 percent level.

SOURCES: Data on varsity athletes from Anderson et al. (1991); data on college students from Johnston, O'Malley, and Bachman (1988). None of the 11 NCAA schools had drug testing programs at the time of the survey (Anderson 1997).

[1]Exceptions to this statement include anabolic steroids, which are performance-enhancing drugs, and smokeless tobacco, which is probably performance-neutral (Schnirring 1995: 25).

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student athletes and by making continued drug use difficult or impossible, increases the cost of athletic participation and will most probably lead marginal student athletes to "quit the team." Freed from the regimen of athletics, these former athletes may revert to the drug-use patterns of their nonathlete peers—who have higher rates of drug usage than athletes, according to Table 1.[2] Thus, the imposition of random, suspicionless drug testing on student athletes will have two separate but opposite impacts on drug use:

1. Use will decrease among those inframarginal athletes who continue to participate.
2. Use will likely increase among those marginal athletes who cease to participate.

The net effect on overall student drug use is ambiguous in sign—overall student drug use may fall or rise after the imposition of testing, and any reduction achieved will likely be smaller than expected.

In this paper, I explore the conditions under which the random drug testing of athletes will lead to the perverse outcome of *increased* student drug usage. As I will show below, the threat of this policy backfiring is not fanciful, but rather is quite real and should worry policymakers and others who are concerned with the high level of drug use among students. Civil liberties issues aside, the random drug testing of athletes may be a very risky policy innovation.

I begin the paper with a look at previous studies on the frequency and efficacy of drug testing, most of which are concerned with workplace environments. After pointing out the contrasts between these studies and my own work, I present the paper's formal model, which bears a close resemblance to the models found in the "compensating behavior" literature begun by Peltzman (1975). I conclude with a discussion of the need for caution and careful follow-up studies during the implementation of random drug-testing programs for athletes.

Previous Contributions to the Drug-Testing Literature[3]

One strand of the drug-testing literature examines the effect of drug-test reliability on the decision to do testing (e.g., Sexton and Zilz

[2]I will assume throughout this paper that all of those categorized as "College Students" in Table 1 are nonathletes. Correcting for this problem would merely reinforce the point I wish to make.

[3]This brief survey is not intended to be exhaustive. It focuses almost exclusively on the recent work of economists and other public policy analysts. For a more thorough review of this literature, see Henriksson (1991).

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1988, Feinstein 1988). Two types of errors are possible with drug testing: the false positive (fingering a nonuser) and the false negative (missing a user). The decision to test rests not only on these error rates, but also on the costs associated with the two types of errors and the number of users and nonusers in the population of interest. For example, Sexton and Zilz (1988: 545) show that testing will be better than nontesting if and only if:

$$(1)\quad \frac{\textit{Cost of False Negative}}{\textit{Cost of False Positive}} \geq \frac{\textit{Likelihood of False Positive}}{\textit{Likelihood of True Positive}} \times \frac{\textit{Number of Nonusers}}{\textit{Number of Users}}.$$

For a host of drug classes they demonstrate that only under fairly stringent conditions will this inequality hold (ibid.: 546).

A more recent line of research focuses exclusively on drug testing in the workplace. McGuire and Ruhm (1993) characterize firms' efforts to distinguish between users and nonusers as a classic adverse selection problem and conclude that *overtesting* is likely in such an environment:

> There can be too much testing because testing is most attractive (least costly) to the workers who are at the lowest risk for drug abuse. Firms then have incentives to institute drug-testing programs in order to reduce the number of drug abusers they employ. This creates a negative externality for non-testing firms, because it reduces the quality of their applicant pool. As a result, the private value to workers of sending the signal that they are drug-free (by their willingness to work in settings with drug testing) generally exceeds the social value of the job sorting efficiencies that testing can bring [McGuire and Ruhm 1993: 21].

Hoyt (1995) presents a more general set of models in which workers not only choose their places of employment, but also choose levels of drug consumption in response to testing decisions by firms. Her empirical findings suggest that testing is an effective deterrent to drug consumption and that drug use and productivity are negatively correlated (ibid.: 231–33).

The model that I present in this paper differs from those just discussed in a number of important ways. First, I examine testing in its best possible light by assuming that it is not only perfectly reliable but also perfectly efficacious. The criticisms I offer of testing would merely be reinforced were the results from the first set of studies introduced. Second, my subjects are students making decisions about extracurricular activities rather than workers making employment decisions. Finally, my focus is on the policy objective of reducing *overall* drug use, whereas the more recent studies have been primarily concerned with the efficiencies arising from better sorting workers or from reducing drug use among one's employees. School officials are presumably concerned with more than just the "productivity" of

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their athletic teams or the frequency of drug use among their student athletes alone.

Random, Suspicionless Drug Testing of High School Athletes: The Formal Model

The model that I present below is a "compensating behavior" model, in which individual responses to a government regulation diminish or even reverse the regulation's intended effect. Peltzman (1975) wrote the seminal piece in this literature, which showed that the presence of seat belts in automobiles caused drivers to drive more recklessly, thereby increasing the risk of injury to pedestrians and partially wiping out the safety gains achieved by seat belts. Subsequent studies have largely confirmed Peltzman's surprising result.[4] A host of papers in the past two decades has found evidence of compensating behavior in response to a number of other government safety regulations.[5] Among the most disturbing is Viscusi (1984), who finds evidence that the mandated introduction of child-resistant safety caps may have *increased* the incidence of analgesic poisonings.

A very recent compensating-behavior paper whose argument almost perfectly parallels my own is Hahn (1996). Hahn finds that the federal government's mandated security enhancements at airports following the TWA Flight 800 crash in July of 1996 will most likely *increase* fatalities. The delays and increased costs associated with these additional security precautions will lead marginal airline passengers to drive, which is a far riskier form of transportation than flying. Hahn predicts that the safety gains to inframarginal airline passengers (those who continue to fly and who are now better protected against terrorist acts, which are extremely infrequent in the United States) will be more than offset by the safety losses of the marginal airline passengers who now choose to drive rather than fly.

The Model's Assumptions

In order for compensating behavior to be an issue in the decision to drug test high-school athletes, several assumptions must hold. First, not only must nonathlete drug usage exceed athlete drug usage, but ex-athletes must also conform to the drug usage patterns of their nonathlete peers. The research that has been done in this area by sports physicians supports both of these propositions. As Table 1

[4]For example, see Crandall and Graham (1984), Blomquist (1988), Asch et al. (1991), and Singh and Thayer (1992).

[5]For an overview, see Chapter 13 (entitled "Consumer Behavior and the Safety Effects of Consumer Product Safety Regulation") of Viscusi (1992).

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shows, strong evidence exists that nonathlete drug usage exceeds that of athletes. Moreover, sports physicians seem to believe that these differences are the result of the strict regimen required for athletic excellence. As Anderson et al. (1991: 102) point out in their article on drug consumption among college athletes, "the considerable physical and mental demands of high-level athletic competition may be incompatible with indiscriminate alcohol and drug use."[6] Ex-athletes, who are by definition no longer subject to these demands, are therefore likely to revert to the drug-use levels of nonathletes.

Second, the rate of athletic participation must not be completely insensitive to the costs of participation. Were the demand for athletic participation among students perfectly price inelastic, no compensating behavior would be possible. Complete insensitivity to cost is highly unlikely, however—a fact of which districts considering the implementation of drug-testing programs are keenly aware. Dorhmann (1996), for example, reports that many school districts hesitate to drug test athletes because "implementing a mandatory program could decrease student participation."

The combination of these two assumptions—that increasing the cost of being an athlete by imposing drug testing will reduce athletic participation and that ex-athletes will revert to the higher drug use levels of their nonathlete peers—guarantees some degree of compensating behavior. Whether such behavior will merely dampen the reduction in drug use or instead generate an increase will depend on a number of factors to be considered below.

A First Look at the Problem

Suppose that there are n students enrolled at a particular high school, of whom n_a choose to be athletes and $n - n_a$ choose to be nonathletes. Moreover, suppose that this distribution of students is an equilibrium one: each student is choosing an alternative that maximizes his or her utility, given the choices of other students. Let d_a and d_{na} be the drug consumption levels of a typical athlete and nonathlete, respectively, before the introduction of testing. On the basis of the evidence in Table 1, assume that $d_a < d_{na}$—that is, athletes consume fewer drugs, on average, than nonathletes prior to the introduction

[6]Given the relative paucity of data on the drug habits of high school athletes, I will assume throughout the paper that the gap in drug consumption rates between athletes and nonathletes is roughly the same in high school as it is in college. High school athletes are generally under less pressure to perform than college athletes, however, so the gap may very well be narrower for the former group than the latter. The usage gap evident in Table 1 should therefore be regarded as the upper bound for high school students.

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of drug testing. Total drug consumption in the student body will therefore be:

$$(2) \qquad (n - n_a)d_{na} + n_a d_a = nd_{na} - (d_{na} - d_a)n_a.$$

Now suppose that the school implements a random drug-testing program for student athletes. I will put drug testing in the best possible light by assuming that it is not only perfectly reliable but also perfectly efficacious: that is, testing not only generates no false positives or negatives but also *drives drug use among athletes to zero.* Of course, such testing imposes a cost upon student athletes, who are now subject to unpredictable privacy invasions[7] and who are no longer able to consume recreational drugs, even in small quantities. Given the higher cost of athletic participation, some marginal athletes will "quit the team" and revert to the drug consumption patterns of their nonathlete peers. Let n_a' be the new equilibrium number of athletes. Total drug consumption in the student body will now be:

$$(3) \qquad (n - n_a')d_{na} = nd_{na} - n_a'd_{na}.$$

Thus, the introduction of drug testing will *increase* total drug consumption in the student body if and only if:

$$(4) \qquad nd_{na} - n_a'd_{na} > nd_{na} - n_a(d_{na} - d_a) \Rightarrow \frac{d_a}{d_{na}} < 1 - \frac{n_a'}{n_a}.$$

Equation (4) says that in order for testing to increase overall drug use, athlete drug use (before testing is introduced) as a percentage of nonathlete drug use must be less than the percentage reduction

[7]Justice Antonin Scalia, who wrote the majority opinion in *Vernonia School District v. Acton*, noted in his opinion that "legitimate privacy expectations are even less with regard to school athletes. School sports are not for the bashful" (*New York Times* 1995: B6). Shutler (1996: 1276) describes Vernonia High School's procedure for obtaining urine samples:

> The student-enters an empty locker room accompanied by an adult testing monitor of the same sex. With male students, each boy selected produces his sample at a urinal, remaining fully clothed and with his back to the monitor, who remains standing twelve to fifteen feet behind the student. Under the Policy as written, the monitor may watch the student while he produces the sample, although at no time are the student's genitals observed by the monitor. The procedure for girls differs in that the student produces the sample in an enclosed bathroom stall, so that the monitor does not observe the sample production but listens for normal sounds of urination. After producing the sample, the student gives it to the monitor who checks it for temperature and signs of tampering and then seals the sample, instructing the student to initial the seal.

Although such a procedure may not violate an athlete's "legitimate privacy expectations," most athletes will view it as a cost of athletic participation, and some will surely cease to participate in order to avoid it.

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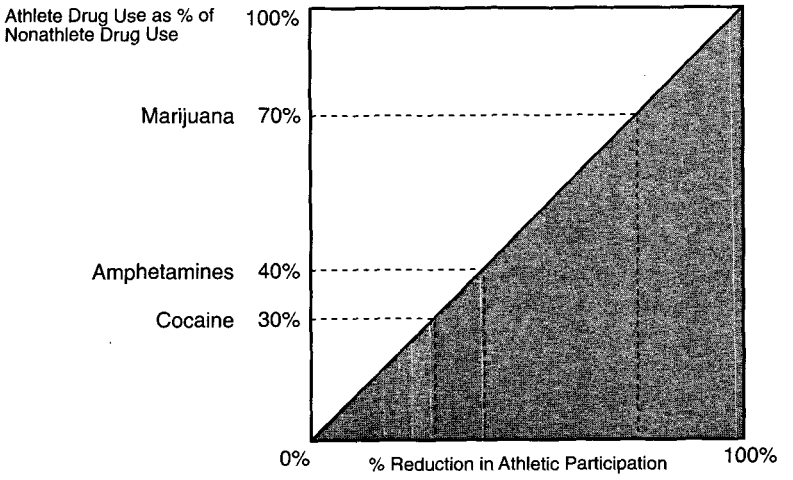
in athletic participation. For example, suppose that athletic participation is cut in half after testing is introduced—a 50 percent reduction. In that case, overall drug use will increase if athlete drug use was less than 50 percent of nonathlete drug use prior to the introduction of testing. If it was exactly 50 percent, there will be no change in overall use: half of the athletes will stay and stop using drugs (recall that drug testing is perfectly efficacious); the other half will quit and double their drug use (emulating their nonathlete peers).

Figure 1 provides a graphical interpretation of Equation (4). The shaded area represents all combinations that result in an increase in overall drug use. One way to determine whether such combinations are likely to occur is to generate estimates of athlete drug use as a percentage of nonathlete drug use from data in Table 1. The ratio of use rates among athletes and nonathletes may serve as a rough approximation to the ratio of use levels if we assume that all users, athlete and nonathlete alike, consume equal quantities.[8] For reasons previously mentioned, however, such estimates will clearly be upper bounds: the strict regimen required of athletes will not only lead to lower use rates among athletes, but will also lead to lower levels of

FIGURE 1

DRUG USE AND ATHLETIC PARTICIPATION



[8]Specifically, the average drug use level in a group is equal to the average drug use level *among users* times the percentage of users in the group. If the average drug use level *among users* is the same across groups, then the ratio of average use levels across groups will be equal to the ratio of the percentage of users across groups.

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TABLE 2

RATIOS OF ATHLETE USE RATES TO NONATHLETE USE RATES (PERCENT)

Drugs	Males	Females
Alcohol	96.8	96.7
Amphetamines	42.9	42.9
Cocaine/Crack	31.6	28.6
Marijuana/Hash	70.7	73.5

SOURCE: Table 1.

consumption among those who do use drugs. Table 2 calculates these ratios of use rates.

The approximate percentages for amphetamines, cocaine, and marijuana are plotted in Figure 1. Some of these percentages are surprisingly low, despite the fact that they are upper bounds. For example, the level of cocaine use among female athletes as a percentage of the level of use among nonathletes is only 28.6 percent. This figure implies that a reduction in athletic participation among women of greater than 28.6 percent would generate an increase in overall cocaine consumption.

One question that naturally arises is whether drops in participation of this magnitude are likely to occur. I will discuss this issue in more detail below, but one important point to keep in mind is that *marginal* athletes are driving the reductions in participation. A school's star quarterback will be unlikely to quit the team over drug testing, but the same cannot be said for second- and third-stringers on the football team. Substantial drops in participation are especially likely in those sports that are more individualistic and/or less prestigious than football (e.g., golf, cross-country, track, wrestling, volleyball).

The Determination of Equilibrium Participation Levels

In order to identify the factors that influence equilibrium participation levels, I will make the model described above considerably more explicit. As before, let d_a and d_{na} be the per-capita drug consumption levels of athletes (pre-testing) and nonathletes, respectively, and let A and NA be the gross utility payoffs associated with these levels of consumption. On the basis of the data in Table 1, I will again assume that $d_a < d_{na}$ and that, moreover, $A < NA$: the low consumption level of athletes affords less utility than the high consumption level of nonathletes.

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Let $P(x)$ be the utility payoff of athletic participation for student x, where students are ranked in descending order according to the strength of their desire for athletic participation. This latter assumption implies that $P' < 0$. One can think of $P(x)$ as an inverse demand curve for athletic participation—as one moves down the inverse demand curve, one encounters students with lower and lower valuations for athletic participation. With this device, I am able to introduce heterogeneity of preferences in a particularly simple way.

An equilibrium will be achieved when each student is choosing an alternative that maximizes his or her utility, given the choices of other students. To find the equilibrium number of athletes, one must merely determine the rank-number of the marginal athlete, for whom the benefit of participation just equals the cost. Formally,

$$P(n_a) + A = NA, \tag{5}$$

where n_a is both the rank-number of the marginal athlete and the (pre-testing) equilibrium number of athletes discussed previously.

Suppose now that random, suspicionless drug testing of athletes is introduced. Testing imposes two distinct costs on athletes: first, it imposes a "privacy invasion" cost of C; second, it imposes a "sobriety" cost of A—as above, I assume that drug testing is perfectly efficacious and therefore drives drug consumption among athletes (and the gross utility payoff associated with it) to zero. These costs lead marginal athletes to "quit the team." Equilibrium is reestablished when all athletes for whom the now higher cost of participation outweighs the benefit have quit. To find the new equilibrium number of athletes, one must again determine the rank-number of the marginal athlete, for whom the benefit of participation just equals the cost. Formally,

$$P(n_a') - C = NA, \tag{6}$$

where n_a' is both the rank-number of the new marginal athlete and the (post-testing) equilibrium number of athletes discussed previously.

I assume that $P(x)$ is an affine function of the form $P(x) = P^* - kx$, where P^* is the highest valuation for athletic participation in the student body and k determines the rate at which these valuations decline. Given this assumption, I can obtain a closed-form solution for n_a in Equation (5) and n_a' in Equation (6). Plugging these solutions into Equation (4), I obtain:

$$\frac{d_a}{d_{na}} < \frac{A + C}{P^* + A - NA}. \tag{7}$$

Thus, overall drug use in the student body will *increase* upon the introduction of testing if Equation (7) holds.

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Comparative Statics

Given that virtually all of the terms in Equation (7) are unknowns, I will write in a probabilistic sense when discussing comparative statics. The likelihood that the introduction of testing will increase overall drug use increases as:

1. $A\uparrow$, $NA\uparrow$: the higher the payoff to drug use among athletes[9] and nonathletes, the more likely is an increase in drug use. Schools with thriving "drug cultures" that encourage experimentation with narcotics are especially likely to experience an increase in overall usage.
2. $d_a/d_{na}\downarrow$: the lower the ratio of athlete drug use to nonathlete drug use prior to testing, the more likely is an increase in drug use. When this ratio is low, the introduction of testing reduces drug use very little among inframarginal athletes (they were using very little to begin with) but increases it substantially among those marginal athletes who quit the team and adopt the drug consumption patterns of their nonathlete peers. The risk is especially high when drugs like amphetamines and cocaine are popular, as Table 2 and Figure 1 demonstrate.
3. $P^*\downarrow$: the lower the highest student valuation for athletics, the more likely is an increase in drug use. One factor that will strongly influence student valuations (including the highest valuation) for athletics is the prestige attached to participation. As noted earlier, low-prestige sports such as track, cross-country, and golf are more likely to see reductions in participation than high-prestige sports such as football and basketball. Schools at which athletic participation in general is not prestigious are especially vulnerable to increases in drug use after the institution of testing.[10]
4. $C\uparrow$: the higher the "privacy invasion" cost of testing, the more likely is an increase in drug use. School officials should clearly do everything within their power to reduce the degradation and embarrassment associated with drug testing if they hope to

[9]By using the Quotient Rule to evaluate the derivative of the right hand of Equation (7) with respect to A, one can determine that an increase in A makes an overall increase in drug use more likely if and only if $P^* - C > NA$. But this condition must hold if *any* students are to choose athletics.

[10]Interestingly, athletics are highly prestigious in Vernonia, Oregon (of *Vernonia v. Acton*). Shutler (1996: 1273) reports that "because of the town's small size and isolated location, school athletics play a prominent role, and the community greatly admires student athletes. Between sixty and sixty-five percent of high school students and approximately seventy-five percent of elementary students participate in one of the District's seven extracurricular sports activities." Vernonia would therefore be less likely, *ceteris paribus*, to see drug use increase after the introduction of testing.

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minimize the likelihood of an exodus from the athletic program and a subsequent increase in overall drug use. Technological advances that make possible less-invasive testing techniques—for example, the ability to test hair samples rather than urine samples (Reuter 1988: 556)—will clearly make this task much easier.

Conclusion

Few people would question the desirability of minimizing the use of drugs among minors. The use of random, suspicionless drug testing of school athletes as a means to achieve this end is more open to question, however. Not only does this policy invade the privacy of a group of students who are relatively unlikely to use drugs, but it also discourages athletic participation and may actually lead to an *increase* in overall drug use. Even in those cases where the adoption of such testing leads to a reduction in overall drug use, compensating behavior by student athletes guarantees that the reduction in use will be smaller, perhaps much smaller, than expected.

Until now, I have assumed that the sole objective of school administrators is to minimize drug use. However, school administrators may have preferences regarding not only the *level* of overall use, but also its *distribution*. The policy of drug testing high school athletes unambiguously increases the variance of drug use in the student population: use falls among the (inframarginal) athletes who continue to participate in sports but increases among the (marginal) athletes who "quit the team" and revert to the higher use levels of their nonathlete peers. Holding overall use fixed, redistributing drug use from low-level users to high-level users may be considered undesirable, especially if the negative health effects are very small for low-level use but extremely large for high-level use.[11] If so, then the policy of drug testing student athletes looks even less attractive that it did before.

The results of this predominantly theoretical investigation suggest the need for careful empirical studies. The currently slow pace of adoption among schools gives researchers time to begin case-by-case examinations of the effect of drug testing on the level and distribution of drug use among students. School administrators, who for political reasons may be pushed into adopting drug testing programs before their usefulness is verified, should be extremely cautious during the

[11]More precisely, if the negative health effects increase *at an increasing rate* with drug use (i.e., the dose-response function is convex), then a mean-preserving increase in the variance of drug use will increase negative health effects.

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initial phase of implementation. If major reductions in athletic participation are observed, a concerted effort should be made to determine the effect of this change on overall drug use and to consider alternative approaches if necessary.[12] The possibility of increased drug use is very real and should be kept constantly in mind when such programs are proposed or adopted.

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Politics as the Art of Confined Compromise

Donald J. Boudreaux and Dwight R. Lee

Politics is commonly called the "art of compromise." This label is thought to be especially appropriate for democratic politics. Elected officials representing different voters meet in legislative chambers to hammer out policies that all constituents can live with. Of course, no politicians or voters receive everything they want in the final legislative package: the need to assemble at least a simple majority to implement any policy almost invariably means that supporters of some policy must sacrifice something of value to others active in the political process. In the public choice literature, this process of political compromise is called "logrolling."[1]

Regardless of the terms employed, few doubt that politics is indeed the art of compromise. Politicians unwilling to compromise are typically labeled ideologues—a label not regarded as a badge of honor among members of the political class. Moreover, politicians who refuse to compromise seldom win and hold on to office for the obvious reason that uncompromising politicians garner too little pork to send home to voters. Successful politicians early on learn the survival value of compromise. Economist Donald Wittman (1995: 154) correctly observes, "That is what good politicians do: create coalitions and find acceptable compromises." Political philosopher Jean Bethke Elshtain (1995: 61) is almost rhapsodic about democratic compromise: "But

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[1]"Public choice" is the study of politics through analytical lenses supplied by economics. Fundamental to public choice is the recognition that people working in the public sector are motivated by the same degree of self-interest as are people working in the private sector. The classic work on both public choice and logrolling is Buchanan and Tullock (1962). A useful introduction to public choice is Mitchell and Simmons (1994).

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compromise is not a mediocre way to do politics; it is an adventure, the *only* way to do democratic politics."

While the centrality of compromise to politics is beyond question, we argue that the current story of political compromise is misleadingly incomplete. Our argument is built of two prongs. First, we show that politics is the art of compromise only at the level of legislative activity; politics is not the art of compromise at the ballot box. While compromise—logrolling—by elected officials is necessary for the successful political careers of these officials, we argue that the institutional structure of democratic elections causes voters to seek representatives who at least appear to be uncompromising. Moreover, we argue that democratic voting causes voters to demand excessively rigid adherence to principle by elected officials. That is, the institutional structure of democratic voting leads voters to demand more rigid adherence to ideological positions than is socially optimal.

Of course, a complication for elected officials is that many voters also want their representatives to bring home the pork. Because bringing home the pork requires compromise with other legislators, each legislator confronts the difficult task of being an expert compromiser in legislatures while appearing to voters to be an uncompromising champion of principle.

Second, we show that democratic politics falls short of achieving optimal compromise not only because of immoderate ideological restraints imposed on representatives by voters, but also because it displaces voluntary market arrangements which achieve a far greater and more inclusive amount of compromise. In fact, politics stymies more beneficial compromise than it promotes. Politics should more appropriately be called the art of *confining* compromise—political compromises are confined to the relatively few parties with ample political power to participate in political bargaining.

Legislative versus Electoral Pressures

The Necessity—and Perils—of Political Compromise

Students of politics have long understood that political success for elected representatives requires these officials to compromise early and often (Mitchell and Simmons 1994: 51–52). Re-election for the representative from south Louisiana's sugar-cane fields requires that he do all he can to ensure that government props up the incomes of American sugar farmers. (The U.S. government transfers wealth from American consumers to American sugar growers by imposing substantial restrictions on the importation of foreign sugar.) But because very few other representatives have sugar growers among their constituents,

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the Louisiana representative wins majority support in the legislature for sugar protection only by offering something of value to representatives from other regions. What the Louisiana representative offers, of course, is his support for government programs desired by representatives from non-sugar-growing regions. "If you vote for my sugar protection, I'll vote for subsidies for urban mass transit," is the kind of deal the representative from south Louisiana makes with representatives from Boston and Los Angeles. A representative from south Louisiana who steadfastly refuses on principle to support government subsidies or import restrictions for any products other than sugar will soon find himself out of office. The reason is that his principled refusal ensures that no other representatives will roll legislative logs with him and, hence, government stops protecting sugar growers from foreign competition. Unwillingness to compromise is not a trait prevalent among successful politicians.

Nothing in the preceding paragraph is new or controversial, for it conveys precisely what people mean when they say that politics is the art of compromise. But the story told in the preceding paragraph is incomplete. While politicians must strike compromises amongst themselves in order to retain favor with interest groups, politicians must not be seen by voters as too willing to compromise. Politicians professing no ideology and unreservedly admitting that their highest skill and calling is to compromise with other politicians do not have long-lived political careers.

As president, George Bush learned this lesson the hard way from his autumn 1990 compromise with congressional Democrats to break his "read my lips, no new taxes" campaign pledge. In one sense, President Bush did what comes naturally to all politicians: compromise first and worry about ideological purity only after all the necessary compromising is done. Bush's problem, however, was that he got caught in the act. His pledge not to raise taxes was the central theme of his 1988 campaign. Thus, when Bush compromised away his commitment to no new taxes, his political rivals easily portrayed him as an unprincipled leader. Even though Bush arguably acted out of noble motives—genuinely believing that a tax hike would promote the worthwhile goal of balancing the federal government's budget—and even though most voters support efforts to balance the budget, Bush's violation of his no-new-taxes pledge was too blatant to be seen as anything other than the action of a politician with no ideological conviction. Bush now understands his political blunder. He sensibly notes, "The biggest mistake of my presidency was that I damaged my credibility by agreeing to a tax increase. . . . I worked out a compromise and it cost me plenty" (Bush 1996).

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Contrast Bush to his immediate predecessor, Ronald Reagan. Although Reagan compromised during his presidency,[2] his communication skills were well-enough refined to deflect voters' attention from his compromises and focus instead on his proudly proclaimed ideological beliefs.[3] Reagan was perceived as one of the most ideologically committed presidents of modern times, and it was this staunch ideological commitment that seems to have appealed most powerfully to voters.

Voters' Ideological Motivations

Voters reward ideological commitment by politicians because the voting process elevates in the voting booth ideological considerations at the expense of pragmatic considerations. As Geoffrey Brennan and Loren Lomasky (1993) argue, the fact that no voter reasonably expects to cast the decisive vote in an election means that each voter incurs no material cost of voting ideologically—even if an ideologically cast vote runs contrary to the voter's material interests.

The logic of the Brennan-Lomasky argument is compelling. It begins with the recognition that the typical voter has both narrow material interests as well as ideological preferences that transcend narrow material interests. Some ideological preferences conform with a voter's material preferences. Under these circumstances, predicting how a voter will vote is easy. For example, a heavily taxed voter who is ideologically opposed to high taxes will almost surely vote, if given the opportunity, to reduce taxes. Importantly, however, ideological preferences can—and often do—run counter to narrow material interests. Many people benefit materially from government actions that these same people oppose on principle.[4] Likewise, many people who stand to benefit materially from government's refusal to act in certain

[2]For example, Reagan dropped plans to eliminate the Department of Energy and the Department of Education, he created a new cabinet-level agency (Department of Veterans' Affairs), and he agreed to several tax hikes. *See* Weidenbaum (1988) and Stockman (1986).

[3]James Bovard (1991: 79–80) relates a telling example of Reagan's rhetorical dexterity. In September 1984 Reagan ordered the U.S. Trade Representative to raise barriers to the importation of foreign steel. But in announcing this protectionist order, Reagan began with a paean to free trade. Bovard (1991: 79) called Reagan's announcement "a masterpiece in trade doubletalk."

[4]Each author of this paper opposes on ideological grounds government funding of higher education. And yet we are both employed by state-supported universities. Were we to vote on a proposition to eliminate taxpayer funding of our universities, we would both vote in favor of the proposition. However, the reader should not be too quick to praise our commitment to principle: because we both know that the outcome of the election does not turn on our individual votes, it is costless for us to vote according to our ideological lights. Our votes in favor of the proposition in fact do nothing to threaten our access to taxpayer funds.

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ways often express ideological support for government acting in these ways. For example, high-income people frequently express support for a large and active government funded by high taxes even though many of these people would be personally materially better off with a smaller government (and, hence, lower tax bills).

The strong probability that voters often express ideological beliefs that diverge from their narrow material interests is clear upon reflection. The fact that millions of people regularly vote in statewide and in national elections proves that voters are motivated by more than narrow material concerns. If each voter was concerned only with maximizing his narrow material welfare, few people would vote. The very act of voting in an election in which the probability of affecting the outcome is practically zero is an act of ideological commitment that cannot be understood as an effort to increase the voter's material well-being.[5]

Given that large numbers of people vote knowing that they individually have no chance of deciding the outcome of an election, it follows that many voters likely have as part of their utility functions some ideological concerns that are not in perfect congruence with their narrow material interests. Being motivated to vote by non-material interests strongly suggests, therefore, that the typical voter often casts his vote ideologically—and that these ideologically cast votes do not necessarily conform with the voter's narrow material interests. Brennan and Lomasky (1993: 36) put the point succinctly: "if the act of voting is a matter of sufficient moral seriousness to induce the individual to go to the polls, it would surely be surprising if moral considerations did not bear on what the voter does when he gets there."

Unlike when a voter's ideology conforms with his narrow material interests, it is much more difficult to predict how a voter will vote when his ideology on the issue in question runs counter to his narrow material interests.[6] Will the voter's narrow material interest dominate

[5]Consider, for example, Brennan's and Lomasky's (1993: 35) observations on the fact that voters on the American west coast continue going to the polls in national elections even after these west-coast voters know the outcome of the election:

> This was in fact the case in both the Reagan victories in the 1980s. Yet voters continued to go to the polls and to cast votes for one or the other presidential candidate long after the result was known. In this case, the voters knew with complete certainty that they could not alter the outcome. Yet they continued to cast presidential votes—in apparently moderated, but still substantial numbers. Presumably they derived benefits from doing so: It is simply that the benefits were not of an instrumental [i.e., material] kind.

[6]Would each of the authors of this paper vote to eliminate taxpayer funding of our universities if we knew that our votes would be decisive? We boast that we would, but the only real test of our boastful claim would be if either of us were in fact given a decisive say on the question of whether or not our universities will continue receiving taxpayer funds. Happily

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his (contradictory) ideological belief, or will his ideology triumph over his material self-interest? Either outcome is possible for any particular voter in any particular election.

Consider an election pitting protectionist candidate Smoot against free-trade candidate Smith. Suppose voter Williams works on a General Motors assembly line and, like candidate Smith, opposes tariffs on ideological grounds. Will Williams vote for Smoot or Smith? It's impossible to say for certain. What we can say, however, is that Williams is *more* likely in the voting booth to express his ideological preference for free trade than he would be to express such a preference if he were given the decisive say on whether or not the U.S. auto industry will enjoy trade protection. The reason is that a vote for Smith costs Williams nothing. With his material interests effectively out of play in the voting booth, Williams' ideological concerns—those that can be satisfied by voting according to one's ideological lights—dominate his narrow material concerns.

While Williams's ideological commitment to free trade may be so resolute that he would vote for Smith even if Williams knew that his vote would be decisive, surely our confidence in Williams's resolve to vote ideologically is higher in those circumstances in which the cost to Williams of an ideological vote is zero. In any actual election, in which no rational voter expects to cast a deciding vote, an auto worker with an ideological preference for free trade will likely express this preference in the ballot box even though a policy of free trade might materially harm this worker (relative to a policy of high tariffs on automobile imports) *and* even if this same worker would vote for protectionism if he believed that the election turned on his vote.[7]

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for us, we are unlikely to be placed in such a predicament.

On the question of the ethics of people ideologically opposed to government programs taking advantage of such programs, see Buchanan and Lee (1995).

[7]Of course, psychological adjustments prompted by cognitive dissonance cause many people's ideological commitments to track tightly their narrow material interests. For example, it is no doubt difficult, if not impossible, to find a sugar farmer ideologically opposed to government trade restraints on sugar.

As a positive matter, we predict that the tracking of a person's ideological preferences to his narrow material interests is negatively correlated with the political security of this person's government privileges. That is, if trade protection for sugar growers were, say, embedded in a constitution that could be amended only with great difficulty, a greater number of protected sugar farmers would be on record opposing sugar protection than when, say, sugar protection enjoys only tenuous legislative support. The reason for this prediction about the relationship between the (perceived) security of political pork and the ideological commitment of pork recipients to the program producing the pork is based on the Brennan and Lomasky logic. The costs of opposition to your pork are lower when your pork is secure than when it is insecure.

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Thus, the correct public choice recognition that voters' representatives must and do engage in logrolling amongst themselves does not mean that voters approve of this logrolling as such, or that logrolling is the reason most voters send representatives to legislatures. Nor does it mean that the bargaining calculus confronting representatives on the floor of representative assemblies is understood or felt by voters.

The general lesson is that voters vote more ideologically than traditional public choice recognizes. Indeed, Brennan and Lomasky might be understood to argue that democratic voting produces *excessive* amounts of ideological sentiment in each election. Because no voter confronts the costs of voting romantically, voters vote more romantically than they would if each confronted the true cost of voting ideologically. In popular elections, romance crowds out realism.[8]

The Brennan and Lomasky argument implies that democratic voting procedures create an externality that has thus far escaped the notice of students of politics. The fact that large numbers of people vote means that each voter can ignore the material costs of casting a vote. Making decisions while ignoring the relevant effects that these decisions impose on others is the essence of externalities. In democratic-vote settings, then, each voter makes electoral decisions without taking account of the full costs of such decisions. Because all voters are immune to the full cost of ideological expression in the voting booth, democratic voting—by fostering imprudent voting—reduces social welfare. Democracies produce excessive amounts of romantic voting just as private markets with inadequately specified or poorly enforced property rights produce excessive amounts of air and water pollution. Democratic outcomes are "polluted" with excessive romance and, hence, governed by too little realism.[9]

[8]Even politicians known to vigorously represent constituents with a dominant, specific interest—for example, representatives from the tobacco regions of North Carolina and Virginia—unfailingly insist in public that the special-interest statutes demanded by such politicians on behalf of their interest groups serve mainly the public welfare. That is, even the most hard-boiled pork barrelers in Congress proclaim that the pork they secure serves ultimately to make all of America stronger, better, or wealthier. *All* politicians find it necessary to portray even their most parochial actions romantically—as part of a principled quest to serve America's best interest. As F.A. Hayek (1979: 10) observed, "it is useful to the legislators to claim that they have been moved by considerations of justice."

[9]Plausible examples of legislative results of the excessive romanticism engendered by electoral voting include the war on drugs, the Superfund statute, and the Clean Air Act of 1990. These legislative commands all demand outcomes that any reasonable and informed person would regard as too costly (e.g., the crowding of scarce prison space with nonviolent drug users, thereby making it more difficult to imprison violent offenders; Superfund's requirement that toxic-waste sites be made cleaner than they were before any toxic wastes were dumped on them, and the Clean Air Act's requirement that billions of dollars be spent solving the nonproblem of "acid rain").

We do not doubt that these and most other statutes also serve narrow self-interest goals;

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Of course, if most voters' ideology happens to support limited government and private property, this "voting externality" increases social welfare by keeping government constrained. But whenever the predominant ideology among voters does not consistently support limited government, the externality unleashed in the voting booth is a negative one. Voters with romantic delusions about the powers and intentions of government will too often summon Leviathan into action. Because too few voters today consistently oppose, on ideological grounds, government intervention, voting generates a welfare-reducing externality.

The romantic mandate issued in elections poses a genuine problem for politicians. Interest groups, unlike voters, are neither rationally ignorant nor shielded from the costs of expressing ideological beliefs that conflict with the material best interests of their members. Suppose, for example, that most sugar farmers object on ideological grounds to government support of agriculture. The sugar lobby would incur heavy material costs if it lobbied to promote this ideology. So, the prospect of the sugar lobby pressing for the easing of trade restraints on sugar would be remote even if most sugar farmers ideologically opposed government assistance to agriculture. Moreover, because they are organized and in a position to exert political influence, the lobbying of sugar farmers has a far greater effect on political outcomes than does any single vote at the ballot box. Therefore, organized interest groups support politicians and policies that promote the material welfare of interest-group members. And politicians who ignore interest-group demands are politicians with underfunded campaign coffers.

What's a politician to do? On one hand, voters demand that their elected officials be men and women of principle. On the other hand, the reality of interest-group politics means that politicians must strike numerous unprincipled compromises—both directly with interest groups wielding political influence, as well as indirectly with other representatives beholden to different voters and different interest groups. Appearing to be an uncompromising champion of principle while simultaneously being virtuoso at the art of compromise is a daunting task.

We are privy to no recipe allowing politicians to pull off such a feat. But we do insist that such feats are regularly accomplished. Successful politicians are those who understand how this game is

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however, it appears that the requisite public support for these statutes is romantic in that the public seems to disregard the necessity of making appropriate tradeoffs (e.g., the greater the amount of resources devoted to the war on drugs, the fewer are the resources available to fight nondrug related violent and property crimes).

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played and are willing and able to play it skillfully. These politicians somehow succeed in portraying their compromises as being fully consistent with principled commitment to voters' romantic visions.[10] Platitudes and political obfuscation combine with voters' rational ignorance enabling skillful politicians continually to strike interest-group deals without sacrificing the romantic mantle.

As a positive matter, then, it appears, first, that representatives are not free to roll logs unconstrained by voters' ideology. The need to appear to legislate in accord with voter ideology is real and puts outer boundaries on politicians' actions. Second, voters' ideological demands are unusually strong and imprudent because democratic voting allows voters to ignore the costs of ideological expression. To the extent that voters ignore this cost, politics is not the art of compromise.

However, a third feature of modern democracy is relevant: representatives in fact compromise (at least in wealthy nations) much more frequently than voters as a group desire. It is not clear, of course, that the world would be a better place if voters always successfully held politicians' feet to the ideological fires. Unchecked romantic visions, if implemented politically, probably contain far more potential for serious harm than does the most corrupt pork-barreling government.[11] Consequently, attractive opportunities for lucrative logrolling

[10]Consider again Bovard's (1991: 79–80) report of President Reagan's use of free-trade rhetoric to justify increased trade protection for the domestic steel industry. Other examples of public-interest rhetoric designed to camouflage special-interest legislation include Sen. Howell Heflin's explanation that textile quotas were necessary to protect "the American dream" (*Congressional Record* 1985: S15300); Sen. Fritz Hollings's (*Congressional Record* 1990: S4901) assertion that tariffs on footwear are justified because such tariffs protect American consumers from the threat of "runaway prices" for shoes; Rep. Ed Jenkins's (*Congressional Record* 1986: H9386) argument that unless all "basic industries" in the United States receive protection from imports, "we shall not be able to lead the free world that all of us want to lead"; and Rep. Sam Gibbons's (*Congressional Record* 1986: H3083) grandiloquent (if illogical) pronouncement that U.S. trade restrictions "serve notice on the world that we stick to the high principles of free and open and competitive trade."

[11]We offer the following hypothesis: the poorer the society, the more likely are elected representatives to focus on ideological issues rather than on logrolling. The reason is that poorer societies have a less-extensive division of labor than do wealthy societies. With a less-extensive division of labor, the opportunities for logrolling are diminished. (In the extreme, if everyone in every part of the country has the same occupation—e.g., everyone is a farmer—there are precious few political exchanges that are mutually beneficial to representatives from different parts of the country.) Casual empiricism supports our hypothesis. Nazi Germany stands out as an example of a nation whipped into a romantic fervor, and whose leaders spent a goodly amount of resources and effort pursuing Nazi romanticism (devilish as it was). Pauperized by World War I and by the Treaty of Versailles, Germany was poor when Hitler rose to power. Today's "ethnic cleansing" in Bosnia, and carnage in sub-Saharan Africa, might also be understood in the same way. Being poor, with little wealth to roll around as logs in representative assemblies, the costs to political leaders in these nations of engaging in romantic crusades are lower than are the costs of romantic crusading to members of the American Congress.

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and pork-barreling may help save democratic society from the worst excesses of romantic politics. Politicians with no opportunity to roll lucrative logs with their fellow representatives incur no political costs to pressing relentlessly for the romantic notions expressed by voters during elections. (Again, elected representatives do not relentlessly represent their constituents on the romantic front because doing so would cost each politician lucrative interest-group support. That is, with lucrative logs to roll, it is too costly for representatives to ignore these logs by focusing exclusively on ideological and romantic issues.) But this fact does not mean that the kind and extent of compromise occurring within political markets is optimal. Indeed, we argue in the next section that political markets achieve much less than the optimal degree of compromise necessary for maximizing human welfare. The reason, in a nutshell, is that the political bargaining table has only a limited number of seats. Those unlucky enough not to have a seat are not party to any political compromise; they have no effective political voice.

Comparing Political Compromise with Compromise in Markets

So far we have seen that the romantic communiqués issued by voters in democratic elections constrain, though by no means eliminate, the ability of elected officials to compromise: politicians' hesitancy to strike compromises rises with the risks of being exposed as ideologically vacuous. Politics is not as compromising as might be thought, for excessive ideological expression by voters constrains political compromise.

But there is more to our story. Labeling politics as the art of compromise makes sense only if politics is compared with the breadth and depth of compromise occurring in other institutional settings. Such a comparison shows that politics does *not* excel at compromise, even if voters put no ideological restraints on the ability of politicians to logroll. We argue here that decentralized markets achieve more extensive and deeper compromise than is achieved by political decisionmaking.

While all parties sidling up to the political bargaining table must compromise amongst themselves, only a relatively small handful of interested parties ever get seats at this table (Gwartney and Wagner 1988: 19–21). Political influence generally requires that people be organized into lobbying groups of sufficient size and with sufficient resources to attract (in competition with other groups) the attentions

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of elected representatives.[12] Individual citizens, as such, rarely have political influence. Moreover, not even all groups of citizens exercise such influence, for free-rider problems may thwart efforts of some groups to remain organized and funded as effective lobbies (Olson 1971). Dairy farmers are an effective political lobby; consumers of dairy products are not.

Politics is weak at compromise not only because voters vote excessively ideologically, but also because politics artificially and unnecessarily limits the number of bargaining parties (Crew and Twight 1990; Twight 1994). Thus parties excluded from the political bargaining table never have their interests on the table to be weighed against the interests of the select few sitting at the table.

Consider, for example, consumers. Because the costs of organizing the large number of consumers into an effective interest group are quite high, it is commonplace—and correct—to observe that consumers are politically unorganized (McCormick and Tollison 1981). And because the costs of organizing producers are often low (relative to the benefits available to successful organization), politically organized producers use the political process to stymie competition at the expense of unorganized consumers.[13] Of course, no particular organized group of producers gets all it wants from the political process: every group must agree to settle for less than any single group would receive if that group were the only organized political block and could then use the state to extract whatever wealth it wished. That is, each interest group must compromise with other organized interest groups.[14] But the interests of unorganized groups are ignored by political processes.

Thus, describing politics as the art of compromise is misleading. Because the value to interest groups of using the political process depends on the inability of other groups to organize effectively and join in the political bargaining, politics may just as accurately be described as the art of *confining compromise*: organized interest groups have incentives to confine the number of parties sitting at the political bargaining table.[15] The result is that the interests of the general, unorganized public typically are compromised by political compromise.

[12]McCormick and Tollison (1981) show that democratic government is largely a process of transferring wealth to organized interest groups from citizens who, for whatever reason, find it too costly to organize into effective political lobbies. See also Tollison (1988).

[13]See, for example, Stigler (1988), Young (1987), and Lee (1982).

[14]For the classic treatment of political compromise within a public choice framework, see Peltzman (1976). Also important is Becker (1983).

[15]Olson (1982: 74) describes the incentives of organized interest groups to increase the complexity of government as well as to restrict the access of others to government.

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In contrast to politics, the market promotes genuine and extensive compromise. The market brings to the bargaining table a much wider and more complete array of bargainers than are brought to the political bargaining table. Inevitable differences in talents, tastes, and circumstances among people create opportunities for mutually advantageous private exchange.[16] In free markets based on private property rights, each person can make buy-and-sell offers individually. Unlike the political arena, the market does not require aligning oneself with an organized interest group as a prerequisite for bargaining.[17] Because almost everyone has something of value to offer to others, everyone has an opportunity to participate in private markets. And to the extent that an individual participates in private markets, that individual has a decisive vote in determining the pattern of market outcomes.

No one making a buy or sell offer in the market can be ignored, for each buy and sell offer is registered as part of the demand or supply for a good, service, or resource. Each buy and sell offer forces every market participant to take account of the valuations expressed by those who make these offers (Coase 1960, Boudreaux 1996). To see how, consider a straightforward example of the sale of a used truck.

If Joe offers to buy Sam's truck for $5,000, the value to Sam of his truck is at least $5,000, even if Sam personally no longer has any use for a truck. Moreover, every other potential buyer of Sam's truck must take account of Joe's offer, even though Joe's offer is not directed at other potential buyers of Sam's truck. If Mary then offers Sam $5,100 for the truck, the value to Sam of the truck rises, immediately upon receipt of Mary's offer, from $5,000 to $5,100. If no one offers more than $5,100 for Sam's truck, and if Sam himself values the truck at something less than $5,100, Mary becomes owner of the truck. Through such bargaining, Mary, Sam, and Joe (along with other would-be buyers of the truck) reach an agreement about the best allocation of the truck. Both Sam and Joe value the truck, but neither values it as highly as does Mary. Both Sam and Joe voluntarily chose to forego the truck rather than forego the amount of money it would cost each to keep the truck from Mary. Of course, each person would like to have the truck as well as the money—that is, each person would

[16]The classic explanation of this point remains Smith (1776).

[17]Of course, private market participants often combine their resources and efforts into joint selling and buying agreements. A firm, for example, is an agreement among certain resource owners to jointly offer for sale the firm's output, and to jointly offer to purchase inputs. The difference between private markets and political markets is that private markets do not require joint activity, while it is impossible to purchase anything in political markets without being aligned with a minimum number of other people all of whom share some special interest in government action.

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prefer not to compromise with others over the disposition of the truck and their money—but, unlike in political settings, such uncompromising outcomes are unavailable in private markets.[18]

To see the nature of market compromise more clearly, it is helpful to compare the market with government's power of eminent domain. Suppose that Mary enjoys the power of eminent domain over Sam's possessions, and with no duty to compensate. With such power, Mary is not compelled to bargain with Sam or with anyone else over the disposition of Sam's truck. Mary simply takes the truck regardless of how little she values it (assuming, of course, that she attaches some positive value to the truck). In these circumstances, Mary compromises with no one. It is Mary's decision *alone* whether or not she or someone else gets the truck. Moreover, she is not required to sacrifice anything of value in exchange for the truck. It may well be that Sam, or Joe, or any number of other people value the truck more highly than does Mary. But no one can ever know these relative valuations unless ownership of the truck is secure against takings and the owner and potential buyers then bargain with each other over the disposition of the truck. Secure ownership rights thus guarantee that all parties interested in the truck must bargain ("compromise") with each other. The truck goes to the person who values it most highly, but this person must pay an amount at least equal to the sum offered by the truck's next-highest-valued user.

Market compromise is based on the necessity of market participants to consider carefully the costs that their decisions inflict on others. A crucial factor behind this necessity to take account of the costs on others is that each person's "vote" in the market is decisive. Because each market participant recognizes that he will, with 100 percent certainty, pay a price for his market choices, he is forced to consider his market decisions carefully.

Consider, for example, a skilled neurosurgeon who becomes romantically attracted to being a full-time poet. Because living the life of a full-time poet imposes costs on others (who are denied the neurosurgery services that this poet would otherwise produce) and because this cost is borne personally by the poet (in the form of lower money income earned as a poet rather than as a neurosurgeon), fewer

[18]As Macey (1994: 185) points out, "While private market exchange transactions benefit both the parties to such transactions and society as a whole, rent-seeking in the public sector harms everyone in society, save the individuals or groups that directly benefit from such transactions. . . . When resources are acquired through consensual market transactions, there are no losers, only winners among the parties to such transactions. . . . By contrast, when resources are acquired through governmental fiat, there generally will be more losers than winners."

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poetically inclined neurosurgeons will actually become full-time poets than would be the case if a neurosurgeon's decision to work as a surgeon or as a poet had no effect on his income. None of this is to say that no neurosurgeon will ever leave the medical profession to work full-time as a poet. But because a decision to quit neurosurgery in favor of poetry is a personally decisive one—if the neurosurgeon chooses to quit the medical profession, his decision is implemented—people do not make such market decisions without weighing as best as they can the costs and benefits of alternative courses of action. In contrast, if the poetic neurosurgeon's occupation were chosen by majority rule by large numbers of citizens, then this person has much less incentive to weigh carefully the costs and benefits of his options—for his choice of neurosurgeon versus poet would likely not be decisive.[19]

Thus, although it is often thought of in quite opposite terms, the market in fact is a highly inclusive forum for compromise. The market brings vast numbers of people together, on a regular basis, so that they all may bargain over the disposition of multitudes of goods and services. The resulting compromises—the pattern of which changes continually as people's tastes change and as new production possibilities emerge—reflect much more accurately than do political compromises the full costs and benefits of alternative uses of resources and constraints on people's behaviors.

Of course, in important ways there is *less* compromise in markets than in politics. If 50.1 percent of voters approve Sunday blue laws, the 49.9 percent of voters opposing these laws must accede to the wishes of their fellow citizens. The requirement that all citizens abide by the wishes of electoral majorities is certainly a requirement for compromise. But not all compromise is meritorious. Forcing businesses to remain closed on Sundays may or may not be socially worthwhile. Because the winning coalition of voters uses coercion rather than voluntary negotiation with all affected parties to prevent Sunday commerce, it is impossible to tell if the net value of Sunday blue laws to members of the winning coalition exceeds the losses suffered by

[19]Regardless of how romantic a person's desire may be to own some good (say, a beautiful painting), contract law compels contracting parties to approach the *process* of exchange nonromantically. Through its imposition of civil sanctions for breach of contract, as well as through its requirement that contracts fulfill certain formal conditions (e.g., the requirement of the Statute of Frauds that certain contracts be in writing), contract law complements and strengthens market exchange by impressing upon all would-be contracting parties the binding nature of their contractual commitments. Contractual expression is decisive for each contracting party. For a more general discussion of the huge social benefits generated by the relatively simple common-law rules of contract, see Epstein (1995).

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citizens preferring that retail shops open on Sundays. In the absence of Sunday blue laws, people who wish not to shop or to open their stores on Sundays are not forced to do so, but nor are people who wish to shop forcibly prevented from doing so. Unlike politics, then, markets compel no compromise where compromise is unnecessary. Sunday blue laws achieve compromise insofar as maintenance of civil order requires that people opposed to such laws heed these statutes. But it is not a kind of compromise that we can trust to maximize social welfare.

Conclusion

Two reasons render politics' reputation as the "art of compromise" misleading. First, the indecisiveness of each voter's vote in democratic elections causes voters to vote too romantically. Voters thus reward politicians for supporting policies consonant with voters' prevailing ideology. Such rewards are forthcoming whether or not such policies pass any reasonable cost-benefit tests. Likewise, voters punish politicians who stray too far from voters' ideological demands. Fear of such punishment stops politicians from compromising as openly and as fully as they otherwise would.

Second, political decisionmaking is overly sensitive to the demands of organized interest groups and relatively insensitive to the demands of unorganized groups. That is, not all parties affected by political choices are represented at the political bargaining table. While (ideologically constrained) compromise is commonplace among politicians representing organized interest groups, the fact that many politically affected people are not party to these compromises means that political compromises are selective, at best.

Private markets, in contrast to political markets, achieve much wider and deeper compromise. Anyone owning alienable property to which others attach some value can bargain in the private market; there is no need for buyers or sellers first to organize into politically stable and influential lobbies. People can, and do, participate in private markets in many different ways. Nearly everyone participates individually as a consumer as well as a seller of his labor and other assets. Many people also participate jointly, through firms, as input buyers and output sellers. Overcoming organization costs is not prerequisite to market participation as it is to effective political participation. Therefore, more people are party to market exchanges than are party to political exchanges—which is another way of saying that private markets achieve compromise among a fuller set of people. To partici-

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pate in private markets, resting on secure private property rights, is to participate in the real art of compromise.

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BOOK REVIEWS

The Capitalist Revolution in Latin America
Paul Craig Roberts and Karen LaFollette Araujo
New York: Oxford University Press, 1997, 214 pp.

It is an optimistic title for a fine and insightful book on Latin America. It may also be premature to speak of a capitalist revolution in Latin America, because we don't know yet if the counter-reform forces will be successful or not. They have certainly gained ground in countries like Venezuela and Colombia, where the "dinosaurs" are back in power. Even in Chile, the Frei administration has been trying to reduce once again the independence of the central bank, is increasing expenditures on failed social welfare programs, and is backing the unions in their attempts to push back the clock on labor legislation.

It is very encouraging that Oxford University Press decided to publish a book on Latin America. For years, publishers in England would say that, to sell thousands of copies, one should write about Nelson; to sell a few hundreds, one should write about Latin America.

That view is somewhat shared by political leaders and pundits in the United States, who nowadays see Latin America just as a source of drugs and illegal immigration. The "certification" charade is nothing more than a failed attempt to hide the fact that there would be no drug problem without American demand. It is just as silly to try and blame uneducated Mexican peasants for taking advantage of bad welfare laws passed by intelligent American college graduates.

The best part of the book is the chapter on "The Blocked Society," which illustrates how a corporatist-mercantilist-interventionist society destroys itself. For readers who have not lived south of the border, it must be difficult to understand the extent of the damage done to institutions by the extreme politicization of society. It should also serve as a warning in the United States, where the constant extension of government into individuals' personal affairs reminds me of Latin America in the early 1960s.

In the case of Latin America, Big Brother was exacerbated by the evil influence and easy money from the likes of the Economic Commission for Latin America (ECLA), the International Monetary Fund (IMF), the

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World Bank, and the Inter-American Development Bank (IBD). The authors write:

> If a society does not seek profits, then it will seek something else, such as subsidies and privileges from the government. . .the result of a system based on perverse incentives. Socialism, whether in Mexico or the Soviet Union, inevitably leads to rent-seeking, or lobbying the government for privileges, as it concentrates economic opportunities in the hands of the state. . . . With government handouts more attractive than private profits, society came to be organized around maximizing political benefits and not economic efficiency. . .stimulating redistribution of existing resources instead of the production of new ones (p. 53).

That is one of the best descriptions of Mexico under the old PRI, of Peronist Argentina, and of social democrat Venezuela I have read anywhere.

The almost natural dislike most Latins have for capitalism is because it is identified as an unholy alliance between Big Business and Big Government: "Shoddy goods at high prices became the norm . . . . The success of firms did not depend on product innovation. . . their success depended on their access to government officials." Wealthy Latin Americans would come to the United States two or three times a year to do their shopping, while the poor became a captive market.

The chapter on "The Economic Transformation of Latin America" does not go far beyond Mexico and Chile. Even there, I think the authors do not stress enough the dissimilarities between the privatization processes carried out in countries such as Mexico, Argentina, and Venezuela vis-à-vis Chile. The former were mainly concerned in getting the highest possible price for the state assets, while Chileans were much more aware that the real goal of privatization is to open markets and bring about real competition. The transformation of public monopolies into private ones brought some benefits insofar as assets are much better cared for by individual owners, but the prices and rates charged for privatized goods and services shot up in the absence of real competition, and thus the reforms often became widely unpopular.

Former Venezuelan President Carlos Andrés Pérez had such contempt for public opinion that he did not even try to sell his reform program. As in Mexico and Argentina, many state enterprises were sold to big corporate groups with solid ties to the presidential palace. Venezuela and Argentina went as far as to "privatize" their international airlines by selling them to Iberia, the state-owned airline from Spain, with disastrous consequences.

Therefore, "the capitalist revolution" has not been as successful as one would have wished. The "dinosaurs" have launched a strong counter-reformation movement with a lot of support from bureaucrats, labor unions, protectionist interests, and the Catholic Church, especially the Jesuits, who have traditionally been very influential in educational circles.

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Now the left in Latin America is blaming everything from global warming to the drop in standards of living on so-called neoliberal policies.

In addition, the close connection between reforming technocrats and multilateral agencies like the IMF, agencies that provoke riots everywhere they impose harsh increases in taxes and in the rates charged for public services as prerequisites for new lending, further confuses people. Marxists and assorted leftists point to the multilateral lending institutions as spearheading ugly capitalism, when for decades those institutions have been building up state sectors with billions of dollars collected from American and European taxpayers to be squandered not only in their palatial buildings in Washington, but on unviable government projects in the Third World.

Write the authors: "Even the successes are expensive compared to private sector development. The cost per job created under international development bank projects has been as high as $900,000 per job, and it is often in excess of $20,000 per job" (p. 170). They remind the reader of the very appropriate name given to those international bureaucrats by the English journalist Graham Hancock: "The Lords of Poverty."

The chapter on "Outdated International Development Institutions" is eye-opening. "Development ideas had come a full circle, formerly Third World populations were told that they had to live in austerity to finance government investment projects, and now they were informed that they had to further tighten their belts in order to bail out the unsuccessful projects" (p. 171).

As Carlos Rangel and the authors of the recent best-seller—*Manual of the Perfect Latin American Idiot*—have clearly stated, Latin Americans did not need much outside help in creating an economic miracle in reverse in the 1970s and 1980s. Unfortunately, however, Citibank and Chase Manhattan financed, right up to the early 1980s, every government project they could find. In addition, foreign aid from Europe and the United States constantly bailed out irresponsible and corrupt governments in Latin America. One wonders if citizens in developed countries thought that capitalism was good for them but not for Latin Americans.

Bill Clinton is the first U.S. president since the World War II not to visit Latin America in his first term. But now, economic globalization and the cybernetic revolution are liberating Latin Americans from interventionist governments. As brains and skills become the region's main resources, politicians will find it increasingly difficult to nationalize and expropriate private wealth. Instead, they will be forced to create a competitive and attractive environment, with low taxes, few regulations, personal security, respect for property rights and the rule of law. That is the road sketched by Roberts and Araujo in their very good book.

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What It Means to Be a Libertarian
Charles Murray
New York: Broadway Books, 1997, 178 pp.

Charles Murray's volume, *What It Means to Be a Libertarian*, is an eloquent manifesto calling for a much reduced role for government, particularly at the federal level. For example, Murray identifies the following federal programs and functions to be eliminated entirely: Social Security, Medicare, welfare, agriculture, housing, training and employment, energy, and the Post Office. He advocates the repeal of most consumer and product safety laws leaving redress to traditional tort and contract remedies. He would also repeal civil rights laws in favor of a constitutional amendment to the effect that (1) no government at any level shall pass any law that requires discrimination by ethnicity, race, religion, or creed; and (2) no government shall pass any law limiting freedom of association for private individuals and groups. Whether one agrees with him or not, Murray is not serving up a watered-down brand of libertarianism.

While Murray credits a number of noteworthies for influencing his thinking in his "Sources and Acknowledgments," from Adam Smith and John Stuart Mill to Milton Friedman and F.A. Hayek, I submit he owes a large unacknowledged debt to Alexis de Tocqueville, who goes unmentioned. In fact, libertarians in general owe a large debt to Tocqueville.

But before recalling the fundamental groundwork laid by Tocqueville to the theory and practice of contemporary libertarianism, or liberalism as it used to be known before the meaning of the terms "liberal" and "conservative" became distorted beyond everyday comprehension, let us review the rationale articulated by Murray for his own brand of libertarianism. It is fair to ask at the outset, what is the end of such radical change as that prescribed in *What It Means to Be a Libertarian?* Put quite simply, to be free and happy. Says Murray: "Limited government leaves people with the freedom and responsibility they need to mold satisfying lives both as individuals and as members of families and communities."

On the always interesting "vice" issues which confront libertarians, Murray, like John Stuart Mill, does not shy away from arguing that freedom means that adults should be able to do in private whatever they please—even if they harm themselves—as long as such activity does not harm others. Thus, he would legalize drugs and prostitution so long as those activities are pursued in a non-coercive, voluntary fashion. (I should add that Murray does not promote those activities; he just believes that individuals and communities will be much better able to protect themselves from any harms inflicted by those activities through private social controls rather than government regulation.)

While Murray's chapter on "Sex, Drugs, and Rock and Roll" is likely to be an attention-grabber, if for no other reason than how one handles the "vice question" seems to sort out various stripes of libertarians, no one can really argue with the proposition that, at least in one sense of

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the word, fewer "vice" laws means more *freedom*. Obviously, if it is no longer a crime to use drugs or visit a prostitute, in a real sense one has greater "freedom" to do so. But from a larger societal point of view, surely the more fundamental questions pertain to the links between freedom and the other side of freedom's coin: *responsibility*. Does more limited government really lead to a more responsible citizenry in ways that contribute to the overall public good? Or, put another way, can government encourage individuals to act more responsibly simply by getting out of the way and expanding their freedom of action?

Murray's answer to those questions is an emphatic "yes." He contends that as government has grown and assumed more and more social welfare functions that were formerly performed by institutions such as the family, church, and community, it displaced the "civil responses" that otherwise would have risen to meet the needs at hand. He cites as examples Social Security and the War-on-Poverty programs that stripped civil institutions such as fraternal and craft organizations of some of the social insurance functions they fulfilled before the New Deal and the Great Society. According to Murray, "If government is not seen as a legitimate source of intervention, individuals and associations will respond. If instead government is permitted to respond, government will seize the opportunity, expand upon it, and eventually take over altogether." And it is at this point that "freedom of association" becomes so important: the more laws of whatever type make it more difficult for individuals to associate freely with like-minded persons to pursue their common objectives, the less likely individuals will be able to work cooperatively to meet needs that government otherwise will step in to meet.

Thus, it is not that government by fiat typically forbids any type of positive response by private persons or civic institutions to meet real or perceived human needs. It is just that human beings have a natural tendency to let someone else take care of a problem, particularly if that someone else claims that he can do it better. This theory of "displacement" holds true, and perhaps even especially so, if that someone is the government. This is because when the government undertakes a program it is almost by definition on the stated—and usually trumpeted—assumption that government can perform the service or function in question better than private individuals or institutions. After all, how many times can we recall a government official saying something to the effect, "We're going to regulate such and so, but the market [or the family, neighborhood, or church] really could perform this function just as well as the government can!"

When government steps in, our individual and collective sense of responsibility is diminished at least somewhat and our sense of dependency is increased. And, such a loss of a sense of responsibility is almost always accompanied by some measure of loss of freedom because government programs or services do not come without strings attached. Of course, the more strings attached—or put less prosaically—the more

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government rules and regulations which bind us, the less freedom we have. As Murray would have it, the less "each person owns himself."

As stated earlier, Murray does not flinch from applying his "hands off" philosophy even to anti-discrimination laws, which he concedes to be a use of government which appears to be good. In defending his position, he argues that the trend lines show that Americans were making great strides in eliminating racial and others forms of bigotry before enactment of the civil rights statutes and would have continued to do so absent their enactment. Whether or not that is true may be debatable. But, more fundamentally, he argues that, in any event, by their very nature anti-discrimination laws necessarily and purposefully impinge on freedom of association, and that the state-imposed loss of any measure of freedom of association, even in pursuit of a seemingly benevolent purpose, ultimately interferes with the ability of private associations to serve as "mediating institutions" which act to limit the role of government in individual lives.

Tocqueville said all that and more, quite eloquently, in *Democracy in America*. Although only 25 years old when he arrived in May 1831 for his 9-month visit to America and only 30 when he published the first part of his great work, Tocqueville was more than just an astute observer of the American scene. He was, of course, a political philosopher of the first rank. Tocqueville is cited most often nowadays by commentators across the political spectrum only with regard to his observations concerning the proclivity of those early Americans to engage in private associational activity, especially activity directed toward common charitable or societal goals. In perhaps the most oft-quoted passage, Tocqueville reported that:

> The political associations that exist in the United States are only a single feature in the midst of an immense assemblage of associations in that country. Americans of all ages, all conditions, and all dispositions, constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds—religious, moral, serious, futile, general or restricted, enormous or diminutive.

While acknowledging a necessary role for government carrying out certain functions, Tocqueville asked: "What political power could ever carry on the vast multitude of lesser undertakings which the American citizens perform every day, with the assistance of the principle of association?"

As a keen student of human nature, Tocqueville recognized the positive role that associational activity could play in an individual's life. By being part of a group that strives to accomplish a common objective, an individual achieves a sense of personal satisfaction. Tocqueville said the heart is enlarged and the mind is developed by the reciprocal influence of men and women working together in their voluntary associations. And it is in this same sense that Murray speaks of voluntary engagement undertaken

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for the benefit of the community as fulfilling an innate need of individuals to live satisfying lives.

But, as a political philosopher, Tocqueville went much further. He predicted that in modern states, including democracies, there almost certainly would be a dangerous tendency toward centralization of power that would threaten individual freedom. In Tocqueville's view, only mediating institutions such as private associations, possibly could moderate such tendency. Even so, he feared for the future because he saw in democracy the potential seeds of its own destruction.

He argued that a democratic regime, by the sheer force of majoritarian canon it embodied, would ceaselessly move in the direction of striving for ever greater degrees of what he referred to as "equality of condition." That continual natural striving for "equality of condition," in Tocqueville's view, inexorably would lead to an ever-increasing encroachment of central government authority at the expense of individual freedom.

But, despite what he understood to be the majoritarian impulse of the populace at large to achieve ever greater degrees of "equality of condition" or leveling of society, Tocqueville understood that human nature is such that "the personal pride of individuals will always seek to rise above the line, and to form somewhere an inequality to their own advantage." Because it is human nature to strive to "rise above the line," Tocqueville thought government would respond by striving mightily to take "each member of the community in its powerful grasp." Then the central government would grow to cover "the surface of society with a network of small complicated rules, minute and uniform, through which the most energetic characters cannot penetrate, to rise above the crowd."

Tocqueville genuinely despaired for individual freedom in the popular democratic societies he envisioned evolving: "I have always thought that servitude of the regular, quiet, and gentle kind which I have just described might be combined more easily than is commonly believed with some of the outward forms of freedom, and that it might even establish itself under the wing of the sovereignty of the people." Or, as he put it more lyrically, when power becomes concentrated in the central government, such power "does not destroy, but it prevents existence; it does not tyrannize, but it compresses, enervates, extinguishes, and stupefies a people."

Pretty strong words from someone whose name usually is invoked today only for describing the "habits of the heart." But it was squarely in the context of his apprehension about the natural tendencies toward too-powerful modern central governments that Tocqueville extolled the virtues of private associations as counterweights. He saw in the American bent for associational activity, particularly manifested during the time of his American travels by the birth of the new temperance societies, an antidote to the natural centralization tendencies of the modern state. Tocqueville did not praise the virtue of associational activities only for the positive contribution to be realized by the beneficiaries of the benevolent

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activity. Rather, the chief virtue of the associational activities, according to Tocqueville, lies in the mediating role private institutions such as family, religious organizations, and community groups play in providing citizens with alternative vehicles for problem-solving that might stave off an excuse for further accrual of governmental authority.

So, Murray owes quite a debt to Tocqueville, one that might well have warranted a mention along with the others in Murray's acknowledgments (on pp. 171–72) of those who have influenced his thinking.[1] For Murray's emphasis on the important links between freedom of association, the willingness and ability of individuals to perform good deeds through mediating private institutions, and the tendency of governments, even democratic ones, to supplant individual liberties gradually and in the most benevolent of ways certainly has deep Tocquevillian roots. In any event, Murray surely would agree that we all would be better off if Tocqueville's early warnings in *Democracy in America* were read more often today in the libertarian vein in which Tocqueville intended.

The fact that Tocqueville laid the libertarian groundwork over a century and a half ago does not diminish Murray's own considerable present achievement. His *What It Means to Be a Libertarian* sets forth in plain and simple English a passionate call for a reduced role for government in our everyday lives. Murray's hope, in my view well-grounded in logic and Tocquevillian understanding of human nature, is that such a reduced government role will spur a rebirth of civic engagement that not only will benefit the objects of such engagement but, as important, will help those so engaged lead more satisfying lives because of the decisions they have made freely about how to live their lives. Tocqueville surely would be pleased if Murray's book moves us at least a little in the classical libertarian direction.

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Asia Rising
Jim Rohwer
New York: Simon & Schuster, 1996, 382 pp.

In *Asia Rising*, Jim Rohwer addresses three questions: Why did the economies of East and South-East Asia grow between 1970 and 1995? Will Asia continue to grow in the next 25 years? And what does the growth of Asia mean for the West?

Rohwer argues that there are four elements that have contributed to the extraordinary economic growth of Asia. First, Asia has a greater

[1]Murray does cite Tocqueville on p. 136: "Alexis de Tocqueville was among the first to marvel at the American genius for voluntary associations."

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quantity of labor supply because its workforce has grown fast and works long hours. Second, Asia has injected a greater amount of capital into the economy because it has a high savings rate. Third, most Asian countries have improved the quality of their labor force through education and training. And fourth, most Asian countries have a set of factors that enhance the efficiency with which the first three elements are combined. Those factors include an enlightened authoritarian government dedicated to economic growth and able to resist the claims of special interests, little provision of public welfare, openness to the outside world, and a central position of the family relative to the state and the individual.

Regarding the future of Asia, Rohwer argues that the keys to Asia's long-term future are (1) whether Asian firms and governments can successfully create more transparent and predictable institutions, and (2) whether Asia achieves a geopolitical balance that will allow its huge and divergent states to live in peace. The author is optimistic about the future of Asia. He believes that Asia's growth will continue for the next 25 years, even though it will slow down around 2000 when institution building gets under way.

When West meets East, Rohwer maintains that the West should be glad about Asia's rise. Far from being a threat, the rise of Asia provides unprecedented opportunities for the West. Asia's relatively cheap but qualified workforce provides Western firms with an attractive place to set up factories. The emergence of a middle class in Asia offers the world's fastest-growing markets for consumer goods and services. Asia is also becoming the fastest-growing market for global capital. If investors, businessmen, and bankers in developed countries succeed in capturing those opportunities, they will benefit from Asia's emergence.

Asia Rising is a rich and optimistic book. Rohwer definitely has an excellent grasp of the dynamics in Asia. He has the ability to describe what has happened in Asia during the past two decades and identify its underlying causes. The book probes aspects of economics, politics, culture, and international relations both in the past and the future. Rarely have I seen a single book that covers so much on the economic performance of Asia.

The four elements of Asia's growth proposed by Rohwer are not new, either empirically or theoretically. Many empirical studies have identified those four elements as the sources of growth in Asia. Economic theories have also made it increasingly clear that, in addition to factors of production, politics, institutions, policies and ideology matter in the performance of an economy. They affect the performance of an economy at a point in time through their effects on the efficiency with which factors of production are combined. They also affect the dynamic efficiency of an economy through their effects on technological changes and the type and amount of human and physical capital that the economy accumulates over time. It is well known that Asia's growth has much to do with its governments, its emphasis on family as the basic social and economic unit, its policy of economic opening, and its public welfare system.

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To the extent that Rohwer propounds a thesis, it is the assertion that the existence of enlightened authoritarian governments that refuse to accommodate the claims of special interests was responsible for Asia's growth in the past and their continued presence is beneficial for the future development of Asia. Rohwer's basic point is that an enlightened authoritarian government that can resist the claims of special-interest groups has a greater capacity to set economic policy according to the national interest and introduce policy changes when necessary. That in turn makes it possible to have low taxes, low levels of government spending, and little provision of public welfare. The basic theme of *Asia Rising* is that Asia has grown faster because it has so far escaped the special-interest trap that lobby-based democracies face.

Rohwer's thesis about the role of an authoritarian government in resisting the demands of special interests is provocative but open to debate, both empirically and theoretically. Empirically, there are Asian case studies which demonstrate that policy formation in Asia has been the outcome of interactions between special interests and state actors, rather than decisions made solely by state actors. MacIntyre (1991) presents three industry case studies which show the rising influence of business interest groups in Indonesia. Laothamatas (1991) documents the rise of interest groups within the business community in Thailand. Hayami (1988) emphasizes the role of agricultural interest groups in shaping the agricultural policies in Japan. Daldwin, Chen, and Nelson (1995) note the influence of interest groups on Taiwan's trade policies. Shirk (1993) stresses that the Chinese economic reform has proceeded by accommodating rather than resisting the demands of vested interests. The policy formation in Asia is clearly not isolated from the influence of interest groups.

Theoretically, Rohwer presumes that the benefits of resisting the claims of special interests are indisputable. Bhagwati and Srinivasan (1980), however, first recognized the possibility that rent seeking by special interests may actually improve welfare in the presence of a distortion. Milgrom (1988) notes that rent seeking inside a firm may motivate individuals to bring their asymmetrically held information to bear on management decisions. Cowen, Gkazer, and McMillan (1985) show that pork-barrel politics and corruption may motivate public officials to provide public goods. Chung (1996) also demonstrates that rent-seeking contest may be socially beneficial when the rent itself increases with the aggregate efforts. Those studies clearly indicate that the net effect of rent seeking by interest groups on overall economic performance is ambiguous. On one hand, it wastes resources that could otherwise be devoted to productive activities and may create distortions in the institutional arrangements. On the other hand, it may offset certain distortionary effects in an economy, produce valuable information to state actors, promote the provision of public goods, and increase the productive efforts put forth by individuals in a rent-seeking contest. As the net effect of rent seeking by interest groups on economic performance is ambiguous, the performance of an economy

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has more to do with the character of the interaction between interest groups and state actors than with its absence or presence. The interesting issues, then, are: Why does the interaction between interest groups and democratic governments in the West seem to slow economic growth while the interaction between interest groups and enlightened authoritarian governments in Asia is associated with economic growth? And why, as observed by Barro (1996), does more democracy seem to raise growth when political freedoms are weak but depress growth when there is already a moderate amount of freedom?

If there exists a nonlinear relation between democracy and economic growth, the future of Asia will depend very much on its democratization process. Whether the Asian countries can preserve the enlightened authoritarian governments given the rise of a middle class, the expansion of economic freedom, and the uncertainty of leadership succession; and whether Asia can maintain its growth when its governments become more democratic are important questions that need to be addressed.

Those remarks notwithstanding, the range of the issues covered in this book is so great that anyone interested in the Asian economies can get something from it.

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Shirk, S.L. (1993) *The Political Logic of Economic Reform in China*. Berkeley, Calif.: University of California Press.

Competition and Finance: A Reinterpretation of Financial and Monetary Economics
Kevin Dowd
New York: St. Martin's Press, 1996, 572 pp.

Dowd reviews the rationale of various forms of business finance—equity, short-term and long-term debt, debt with covenants, and callable or convertible debt. Information problems and moral hazard come into the story. All that leads into discussions of corporate management and the market for corporate control, the rationale of bankruptcy provisions (and the asserted inexpediency of allowing an unsuccessful management to continue running a firm during reorganization), and the rationale of limited liability and extended liability. Because no contracts can cover all possible contingencies in complete detail, borrowers', lenders', and investors' *reputations* are important; Dowd thus illuminates one link between economics and ethics. He further discusses financial intermediation and banking in particular, omitting tedious details of institutions in particular times and places.

Along with several other contemporary economists, Dowd advocates abolishing government money and allowing banks, disciplined by competition, to issue notes and deposits denominated in a dollar defined by a comprehensive bundle of goods and services. For everyone's convenience, the banks would redeem their issues not directly in those miscellaneous goods and services but *indirectly*: a $1 note would be redeemable in whatever amount of some convenient redemption medium (perhaps gold or specified securities) had the same actual market value as the standard bundle.

Some early expositions of this scheme spoke of "separation" of the unit of account (UA) and medium (or media) of exchange (MOE). Dowd objects, stressing the convenience of MOE denominated in the UA instead of fluctuating against it. "Separation" was a misleading term. It meant that the UA is not defined by any MOE (unlike the current fiat U.S. dollar, which is defined by nothing other than the coins, banknotes, and deposits issued by the Treasury and Federal Reserve). Instead, the UA is defined *separately*—by the bundle of goods and services. Competition in serving the public's convenience forces issuers of MOE to denominate their issues in the UA so defined, yes; but the various MOE thus link themselves to the unit without defining it. (One exception verging on literal separation is still conceivable: Banks might allow checks denominated in the UA to be drawn on equity mutual funds that *would* fluctuate in value against the UA.) Unlike the U.S. government, private competing issuers cannot expect the public to continue regarding their dollar bills as being worth—and even as defining—one dollar, regardless of how they may mismanage their issues.

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The indirect redemption described so far might still be awkward in various ways; so Dowd, building on hints by W. William Woolsey and Scott Sumner, proposes achieving essentially the same result through what he calls "quasi-futures contracts" (QFC). Here is how I understand—or misunderstand—this unfamiliar scheme.

Money-issuing banks would stand always ready to make contracts whereby one party delivers $1 currently and the other party undertakes to repay, a specified number of months later, $1 + interest, all multiplied by the price index prevailing at that future time (whether it turns out to be 1.00, 1.06, 0.98, or whatever). (The initial $1 payment reflects the target price level of 1.00, corresponding to the bundle definition of the UA and to the indirect quasi-redemption of money in the standard bundle.)

The banks thus stand ready to accept bets on the price level placed in either direction in unlimited amounts by members of the public. (Banks will presumably obtain adequate guarantees of their counterparties' creditworthiness.) If arbitrageur-speculators expect the future price index to stand above 1.00—perhaps because the current index already does—they pay $1 currently in hopes of receiving a future amount increased by more than the interest. Their current payments, which are in effect presentations of money for redemption, remove money from circulation, tending to have an antiinflationary effect and to keep down the expected future price level. If, conversely, arbitrageur-speculators expect the future price index to stand below 1.00, they opt to receive current payments from the banks in hopes of repaying a correspondingly reduced amount. Meanwhile, the banks' current payments expand the money stock, tending to have an antideflationary effect on the price level.

Such QFCs in either direction, as appropriate, would tend to maintain the current and expected future price levels always close to the target stable level. The deviations and corrections mentioned above would probably not be sizable; they merely serve an expository purpose in explaining the stabilizing forces at work. In effect, the public's bets on inflation or deflation, with the banks committed to being counterparties, forestall both inflation and deflation. Dowd reviews various objections to money of stable purchasing power and answers them to his satisfaction (and almost to mine).

One potential objection to QFCs seems not to be decisive after all: Wouldn't issues of new money to cover banks' betting losses destroy the scheme by making an incipient inflation even worse? Hardly. A bank so behaving would worsen its adverse balance at the clearinghouse. Such a danger would compel the bank instead to cover its losses and redemptions of money by contracting its loans and deposits—by shrinking in size. Such contraction, generalized, would exert appropriate antiinflationary pressure. In the opposite situation of incipient price deflation, any issues of new money to cover QFC losses would have an appropriate antideflationary effect.

Dowd supposes that the central bank would initiate the issue of QFCs and then be abolished, leaving the scheme to "the banks" (p. 37, chap.

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14, p. 473). He leaves crucial details unexplained. Would the private banks operate the QFC scheme independently or collectively? It is understandable why each bank, under competitive pressure, should commit itself to redeeming its own already issued notes and deposits in QFCs. But what reason does an individual bank have to make QFCs in the opposite direction, issuing new money of its own even at the instigation of noncustomers?

Furthermore, an individual bank would hardly find prices quoted separately in its own and other banks' notes and deposits. Nor, probably, would its own issues circulate at an exchange rate other than par against the issues of other banks. Either they circulate at par or the bank defaults in settling its clearing balances and suffers the consequences. Why, then, should any one bank among many concern itself with the general price level? Perhaps the individual bank feels appropriate pressures from deficits or surpluses at the clearinghouse rather than directly from the price level; but how, then, do QFCs come into the story? Dowd's answers to questions like these should be illuminating. (Lawrence White and Roger Garrison, "Can Monetary Stabilization Policy Be Improved by Using CPI Futures Targeting?", forthcoming in *Journal of Money, Credit, and Banking*, should also be helpful.)

Echoing what he has written before, Dowd argues for "option clauses" whereby issuers of redeemable banknotes (and deposits?) might postpone redemption in times of difficulty, meanwhile paying a penalty rate of interest. He ignores published arguments about why, especially under modern conditions, the option clause would be unattractive for both banks and their customers.

Summarizing Knut Wicksell's presentation in 1919 of what later became known as the "paradox of indirect convertibility," Dowd curiously cites an English-language article whose title refers to a quite different topic and that does not appear in the cited volume of *Ekonomisk Tidskrift*. He omits citing the Swedish-language article in the same volume where Wicksell *does* present the supposed paradox. This and occasional other slips, as in a few of the symbols, keep me from testifying to the accuracy of everything Dowd says. (By the way, I urge publishers not to allow (or require) fragmentation of the discussion between text and lengthy notes, with the notes inconveniently located at the ends of the individual chapters.)

Still, my overall assessment of the book is strongly positive. Dowd defends the method of conjectural history. He employs it to reason out how the monetary and financial system might have evolved without government control. Understanding how things would work out under laissez faire is logically prerequisite to intervention to modify their working. If mainstream theory may legitimately build models of imaginary worlds—of identical, immortal persons interacting under perfect competition, and that sort of thing—surely it is legitimate to theorize about how things would work out under conditions that have never yet existed.

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Karl Popper said that we hatch rival theories and try to shoot them down, tentatively accepting ones that withstand attempted refutation. We make our theories die in our stead. Similarly, we may hatch rival institutional reforms and use economic theory to try to shoot them down, sparing ourselves the pains of regimes that would prove flawed in practice. Coming early in the book, Dowd's embarkation on a conjectural history of almost complete financial laissez faire provides a convenient preview of subsequent chapters and whets the reader's interest in just how Dowd will argue for his announced conclusions and recommendations.

As for the supposed political impossibility of the recommended reforms, Dowd ends with a ringing denunciation—is he echoing Clarence Philbrook and W. H. Hutt?—of scholars' practicing "political realism." "Economists should not accept the role of courtiers, only willing to tell those in power what they want to hear." The job of scholars is to speak the truth as they themselves understand it.

Leland B. Yeager
Auburn University

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THE PRESERVATION OF LIBERTY

If national institutions, calculated for the preservation of liberty, instead of calling upon the citizen to act for himself, and to maintain his rights, should give a security, requiring, on his part, no personal attention or effort; this seeming perfection of government might weaken the bands of society, and, upon maxims of independence, separate and estrange the different ranks it was meant to reconcile.

—Adam Ferguson

An Essay on the History of Civil Society.
Edited by Fania Oz-Salzberger (New York:
Cambridge University Press, 1995), 182.

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